Financial reporting on insurance contracts by South African short-term insurers

by

INNOCENT CHEMHERE

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Supervisor: Ingrid Baigrie

Co-Supervisor: Prof Danie Coetsee

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DECLARATION

I certify that the limited scope-dissertation submitted by me for the degree Master's of Commerce (International Accounting) at the University of Johannesburg is my independent work and has not been submitted by me for a degree at another university.

INNOCENT CHEMHERE

Abstract

The purpose of this research is to assess the changes introduced by International Financial Reporting Standard 17: *Insurance Contracts* (hereafter IFRS 17) compared to the current accounting model for short-term insurance contracts in South Africa. Short-term insurance contracts, as they are known in South Africa, are the same as non-life insurance contracts in terms of the International Accounting Standards Board's (hereafter IASB) insurance accounting terminology. The first part of the research describes the current accounting model, while the remainder of the research analyses IFRS 17 and its application to financial reporting for non-life insurance contracts using the simplified measurement approach of IFRS 17.

Phase I of the IASB's insurance project resulted in the issuing of IFRS 4 *Insurance Contracts* (hereafter IFRS 4) in 2004. IFRS 4 established definitions, selected specific accounting policies, the requirements for changing those policies and disclosure requirements for issuers of insurance contracts. IFRS 4 was issued as an interim standard and did not establish any recognition and measurement principles for insurance contracts. Consequently, South African short-term insurers adopted an accounting model that included IFRS 4, Circular 2/2007, the Financial Sector Conduct Authority's (hereafter FSCA) statutory reporting guidance and Advisory Practice Note (APN 401). Circular 2/2007, which was issued by South African Institute of Chartered Accountants (hereafter SAICA) in 2007, provides accounting guidance for the recognition and measurement of short-term insurance contracts. The FSCA's reporting framework provides presentation guidance, while the Short-Term Insurance (hereafter STI) Act's Board Notice and APN 401 provide valuation guidance for short-term insurance liabilities. These pronouncements constitute the current accounting model for short-term insurance in South Africa.

Phase II of the IASB's insurance project resulted in the IASB issuing IFRS 17 in 2017. The key changes from IFRS 4 to IFRS 17 relate to the recognition, measurement and presentation of insurance contracts. The current research concludes by assessing the changes between the current accounting model and IFRS 17's Premium Allocation Approach (hereafter PAA) model, which is the simplified measurement approach of IFRS 17 referred to in the first paragraph. Although the PAA model has its limitations, overall it adequately addresses the

deficiencies of the current accounting model used for short-term insurance contracts issued in South Africa.

KEY WORDS: APN 401, Circular 2/2007, IFRS 4, IFRS 17, Insurance contracts, Premium Allocation Approach, Short-term insurance.

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List of abbreviations and acronyms

APN	Advisory Practice Note
ASSA	Actuarial Society of South Africa
CFO	Chief Financial Officer
DAC	Deferred Acquisition Costs
DSOP	Draft Statement of Principles
FCR	Financial Condition Reporting
FRSC	Financial Reporting Standards Council
FSB	Financial Services Board
FSCA	Financial Sector Conduct Authority
GAAP	Generally Accepted Accounting Practice
GMM	General Measurement Model in terms of IFRS 17
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBNR	Incurred But Not Reported
IFRS	International Financial Reporting Standard
JSE	Johannesburg Stock Exchange
OCI	Other Comprehensive Income
OCR	Outstanding Claims Reserves
PAA	Premium Allocation Approach in terms of IFRS 17
SAICA	South African Institute of Chartered Accountants
SAM	Solvency Assessment and Management
SARS	South African Revenue Service
STI	Short-term Insurance
UPP	Unearned Premium Provision
VAT	Value Added Tax

Chapter 1. Introduction, research methodology and research outline

1.1 Background

After two decades of working on the insurance contracts project with the aim of producing a comprehensive insurance financial reporting standard, the International Accounting Standards Board (hereafter IASB) issued the International Financial Reporting Standard 17 *Insurance Contracts* (hereafter IFRS 17) in May 2017. The project started in 1997 and was divided into two phases (IASB, 2017), namely Phase I, completed in 2004 and Phase II, completed in 2017.

Phase I, which resulted in the issuing of IFRS 4 *Insurance Contracts* (hereafter IFRS 4), establishes limited principles for insurance financial reporting, and provides certain definitions and the requirements for changing the insurer's existing accounting policies. Other principles established in IFRS 4 are the requirement for an insurer to perform a liability adequacy test at each reporting date, principles of shadow accounting and the disclosure requirements for insurance contracts. IFRS 4 allows for an exemption from applying International Accounting Standard 8 *Accounting Policies, Changes in Accounting Estimates & Errors* (hereafter IAS 8), when selecting or developing accounting policies for the recognition and measurement of insurance contracts (IASB, 2004).

The reason for incorporating stricter requirements for changing the insurer's existing accounting policies and the IAS 8 exemption is that IFRS 4 does not establish any measurement and recognition principles for insurance contracts. Even though these existing accounting practices were not established by the IASB, the Board allowed entities to continue applying these accounting policies until completion of the second phase (Phase II) of the insurance project (IASB, 2004: para. 13). The IASB indicated that it did not intend to cause significant disruptions to the existing accounting practices by introducing interim changes in Phase I, which would possibly change again in Phase II (IASB, 2004: para. BC78).

To achieve some consistency in the accounting for short-term insurance contracts in South Africa, the South African Institute of Chartered Accountants (hereafter SAICA) issued an accounting guide in February 2001 to address the recognition and measurement of short-term insurance contracts. This guide was titled: *Accounting Guide on Short-term Insurance*. This guide has subsequently been replaced by Circular 10/2006, which was later replaced by the current Circular 2/2007: *Recognition and Measurement of Short–Term Insurance Contracts*. IFRS 4 and the Circular do not address all areas of short-term insurance accounting, for example, both pronouncements are silent about the presentation of insurance contracts.

The Financial Sector Conduct Authority (hereafter FSCA), previously the Financial Services Board (hereafter FSB), is the regulator of insurers in South Africa. The FSCA prescribes the submission of short-term insurance returns by short-term insurers quarterly and annually. The available guidance from these FSCA short-term insurance returns form part of the current accounting model for short term insurance contracts in South Africa.

IFRS 4 and the Circular do not provide sufficient guidance on the measurement of insurance contract liabilities. Actuaries generally perform valuations of insurance contract liabilities as this is a complex area of regulatory reporting. These valuations are also relevant for the purpose of financial reporting, hence the actuarial valuations are part of the current accounting model for short-term insurance contracts. The valuation guidance for the insurance liabilities is issued by the Actuarial Society of South Africa (hereafter ASSA), which is the regulatory body of the actuaries who perform these valuations.

ASSA issued Advisory Practice Note 401: *Establishing Technical Provisions for Short-Term Insurers* (hereafter APN 401) in 2013 to provide actuarial guidance when determining certain technical provisions. In terms of the regulatory terminology, insurance assets and liabilities are known as technical provisions. These provisions are amounts set aside to meet all liabilities arising from insurance contracts (ASSA, 2013).

APN 401 is based on the requirements of the Short-term Insurance Act's *Board Notice 169 of 2011* (hereafter Board Notice) (ASSA, 2013). The Board Notice is a regulatory reporting statute for short-term insurers issued by the FSCA, the registrar of short-term insurers. It prescribes the requirements for the determination of the values of assets and liabilities of short-term insurers (South Africa, 2011) for the purpose of regulatory reporting in South Africa.

Phase II of the IASB's insurance project was the result of wide consultation, which included publication of a discussion paper on insurance contracts in 2007, which received 162 comment letters. This was followed by the release of an exposure draft on insurance contracts in July 2010, which received 251 comment letters. The IASB revised the 2010 exposure draft issued in 2010, and then released the 2013 revised exposure draft, which received a further 191 comment letters. The IASB finalised Phase II after considering input from the following sources:

- The Insurance Working Group consisting of financial executives, auditors and actuaries, including regulators, which was established in 2004;
- Field work conducted in four separate rounds in 2009, 2011, 2013 and 2016; and
- More than 900 meetings with various role players in financial reporting, including preparers, users, auditors, actuaries and regulators, in order to understand their financial reporting concerns on the basis of the 2010 and 2013 exposure drafts (IASB, 2017).

After consulting widely on the Phase II proposals, the IASB's objective was to complete the insurance project from its interim status in IFRS 4 (Phase I) to a comprehensive standard covering all aspects of insurance financial reporting. IFRS 17 is a one-size-fits-all fix intended to address the financial reporting needs of insurers and other entities that issue insurance contracts. In terms of the South African insurance legislation, insurance contracts are regulated under non-life (short - term) insurance, life (long-term) insurance and medical schemes.

1.2 Research problem

The main issue for consideration in this research is the extent to which IFRS 17 provides an adequate model for the financial reporting of short-term insurance contracts. Adequate accounting guidance links to the objective of the relevant IFRS. The Objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents its contracts (IASB, 2017: para. 1). Thus, this research assesses the adequacy of the changes between the current accounting model for short-term insurance contracts and IFRS 17's requirements for similar contracts. The analysis of the changes between the two accounting models will determine if IFRS 17 is an improvement from the existing accounting model.

Following the brief background above, the question that arises is:

> *Do the changes introduced by IFRS 17 provide an adequate financial reporting solution to address the deficiencies in the current financial reporting model?*

IFRS 17 introduces a new measurement model which is based on fulfilment cash flows. The measurement model, which will be referred to as the general measurement model (GMM) in this research, is based on fulfilment cash flows because insurance contracts are generally serviced through collecting insurance premiums and settling the insurance obligations. According to the Conceptual Framework for Financial Reporting (hereafter Framework), fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability (IASB, 2018: para. 6.17). IFRS 17 also allows a simplified measurement model to be applied to the measurement of some insurance contracts that meet the eligibility criteria of the standard. The simplified model is called the premium allocation approach (hereafter PAA) (IASB, 2017: para 53).

Reference to the PAA throughout this research refers to a complete accounting model for contracts that qualify for measurement applying the standard's practical expedient, including the recognition, presentation, disclosure, modification and derecognition of insurance contracts. The GMM and the PAA models are similar in all these respects except that the PAA model allows for a simplified measurement method that does not separately identify the components of the GMM, which are the future cash flow estimates, discount rates, risk adjustment and the contractual service margin.

1.3 Research objectives

Short-term insurance is a specialised sector of the insurance industry with unique information needs based on the financial statements of the insurers. The objective of this research is to assess the adequacy of the changes that will occur in the financial reporting regime of short-term insurance contracts as a result of the issuing of IFRS 17 in 2017. To achieve this objective, the following steps will be taken:

- Describing the existing accounting model for short-term insurance, which is based on IFRS 4, Circular 2/2007; and the regulatory reporting requirements;

- Describing the financial reporting requirements for short-term insurance contracts in terms of IFRS 17; and
- Assessing the adequacy of changes from the current accounting model to IFRS 17's PAA model for short-term insurance.

Figure 1.1 provides a summary of the format that will be used to address the research objective.

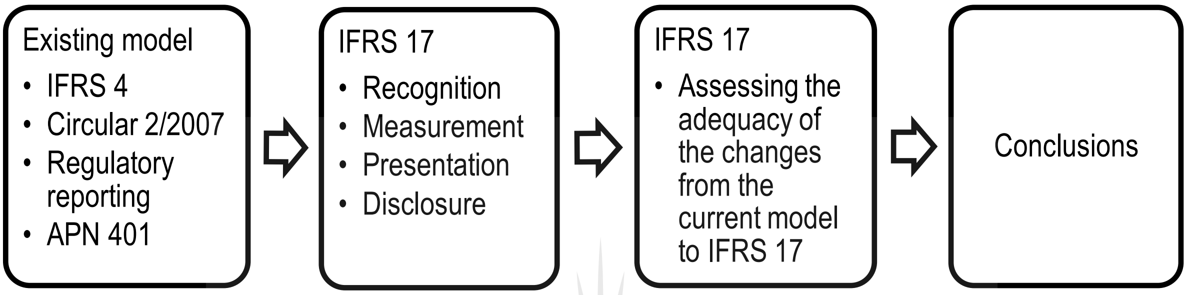

Figure 1.1: Research objectives

Source: Own construction

1.4 Research methodology

According to some accounting scholars, there are strong views that accounting as a discipline lacks accounting theory. They believe accounting research has failed to develop accounting theory (Inanga & Schneider, 2005; Gaffikin, 2008; Coetsee, 2010). There is little consensus on what constitutes accounting theory, but some believe that it could be similar to generally accepted accounting practice (Cluskey, Ehlen & Rivers, 2007). Cluskey, *et al.* propose that accounting practitioners need accounting theory, similar to a conceptual framework, to guide and inform accounting practice. According to Paton and Littleton (1970), accounting theory can be described as a coherent, coordinated, consistent body of doctrine that could be expressed as standards (Paton & Littleton, 1970; Cluskey, *et al.*, 2007).

Consequently, it is concluded that accounting as a discipline lacks an adequate theory on which practice can be based, but is based on doctrines that have been developed into the accounting Framework and standards. Scientific research methodologies are therefore not appropriate for the purposes of this research, as the purpose of the research is to assess the adequacy of existing and new practices and standards and how these are applied in the accounting for short-term insurance contracts in order to provide accounting information to users that is useful for economic decision making. These practices and standards represent accounting doctrines developed by various accounting bodies and standard setters over a period of time in the form of accounting regulation.

Accounting regulation is a continuous process that entails the development and amendment of accounting standards by the standard setters. Preparers and users of financial statements interpret and apply accounting standards, while academics seek to identify problems with the standards or their application and suggest improvements (Van der Spuy, 2015). Prescribing the way accounting should be done does not produce accounting theory, but is a common way of reporting and interpreting financial statements. In the absence of acceptable accounting theory, accounting regulation provides statements of best practice and seeks to attain greater uniformity in accounting practice (Gaffikin, 2008).

Since accounting practice is based on these best practice statements, otherwise known as accounting standards and guides, it is clear that these standards contain accounting doctrines developed over time by standard setters. According to Hutchinson and Duncan (2012:2), a doctrine is "a synthesis of rules, principles, norms, and interpretive guidelines". Consequently, this research follows a qualitative approach, which, firstly, describes the accounting doctrines currently applied to short-term insurance contracts in South Africa and, secondly, evaluates the changes that are introduced by IFRS 17 to the accounting for these contracts.

Due to limited available literature on insurance accounting and the lack of accounting theory to evaluate the current and proposed insurance accounting practices, it was decided that a doctrinal research methodology would be the best approach to use for this research. Doctrinal research is by its nature a qualitative research methodology. Doctrinal research is primarily a core legal research method, which can also be applied to accounting research. According to Hutchinson and Duncan (2012), doctrinal research is research into law and legal concepts. Doctrinal research is a process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary (Coetsee & Buys, 2016).

In this research, insurance accounting doctrines are identified and analysed with the objective of assessing their adequacy in addressing the insurance accounting requirements of users. The purpose of reviewing the current accounting model is to identify its deficiencies. The purpose of performing a literature review of IFRS 17 is to assess how it addressed the deficiencies identified in the current accounting model. According to the Pearce Committee, doctrinal research is “research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments” (Hutchinson & Duncan, 2012:15).

The Pearce Committee of the Australian Law Schools identified reform-oriented research, which is defined as “research which intensively evaluates the adequacy of existing rules and provides recommendations where deficiencies are identified” (Hutchinson & Duncan, 2012:15). Reform-oriented doctrinal research was the most appropriate approach for this research paper.

1.5 Research scope

This research focuses on accounting for short-term insurance contracts issued and reinsurance contracts held and regulated under the Short-term Insurance Act of South Africa (hereafter STI Act). In terms of the STI Act (South Africa, 1998: sec. 1), a short-term policy means the following types of policies: engineering, guarantee, liability, miscellaneous, motor, accident and health, property, transportation; or a combination of any of these policies. The definition of a short-term insurance policy does not specify the coverage period or term limit, also known as the contract boundary, which makes these policies short-term policies. Hollard Insurance Company (2019) defines short-term insurance as protection intended to provide financial coverage as needed in the short-term.

Since this research focuses on short-term insurance contracts only, it is necessary to briefly discuss what constitutes “short-term” in the context of insurance contracts in South Africa. The STI Act lists the types of policies classified as short-term contracts, but does not define “short-term”. These policies, listed above, under the definition of an insurance contract in terms of the STI Act, include accident and health policies. However, the definition of an accident and health policy under the STI Act specifically excludes policies issued by medical schemes in terms of the Medical Schemes Act (South Africa, 1998: sec. 1). Hence, this research excludes policies issued by medical schemes, even if those policies are insurance contracts as defined in IFRS 4. The research scope specifically focuses on short term insurers that had adopted the regulatory reporting requirements of the FSCA.

According to Mackenzie, Njikizana, Coetsee, Chamboko, Colyvas, Hanekom and Selbst (2014:861), short duration insurance contracts cover short periods, usually one year or less. IFRS 17 does not define short-duration contracts, but the PAA measurement approach under IFRS 17 permits insurance contracts to be measured using the simplified model if the results of measuring the contracts using the simplified model do not differ materially from applying the general model.

The IASB uses a coverage period of one year (or less) as an operational simplification to determine what constitutes a short-duration contract that is eligible for measurement using the simplified PAA approach (IASB, 2017). The coverage period is the period during which the entity provides coverage for insured events (IASB, 2017: Appendix A). IFRS 17 does not classify insurance contracts for the purpose of financial reporting, but establishes uniform accounting principles for all insurance contracts, taking into account the simplified measurement approach described above.

In its *Value Added Tax (hereafter VAT) 421 Guide* for Short-Term Insurance, the South African Revenue Service (hereafter SARS) defines short-term insurance as non-life insurance (SARS, 2013). SARS notes that, generally, short-term insurance operates on an annual or monthly basis and can be terminated by either party to the contract, hence the term “short-term”. The policy types listed in the STI Act can cover any duration, and some do not specify term limits but rather provide that cover is conditional on payment of premiums by the policyholder. The contract usually specifies the period covered by these premiums. The premium payment interval is not a deciding factor when determining whether or not a contract is short-term.

Having considered the various definitions in the relevant literature, the most appropriate classification of insurance contracts falling within the scope of this study are property and casualty insurance contracts, also generally known as non-life insurance. Non-life insurance contracts fall under the policies defined as short-term insurance contracts under the STI Act (South Africa, 1998). Therefore, throughout this research, it is assumed that short-term insurers have elected to use the PAA for all contracts that are eligible for this model.

1.6 Scope limitations

This research is confined to accounting for short-term insurance contracts in South Africa, commonly known as non-life insurance contracts. The research covers financial reporting for insurance contracts that meet the criteria for applying the PAA described in IFRS 17. The literature reviewed for the purpose of this research includes all financial and regulatory reporting guides, standards and practice notes in issue as at the date IFRS 17 was issued: May 2017. However, the identification and definitions of insurance contracts according to IFRS 17 are beyond the scope of this research. Insurance policies issued in terms of the Long-Term Insurance Act and the Medical Schemes Act of South Africa are also excluded from the scope of this research.

1.7 Research structure

To address the research objective, the remainder of this research is divided into chapters as follows:

Chapter 2 – Current accounting model for short-term insurance contracts

This chapter describes the current financial reporting model for short-term insurance contracts. The current accounting model is based on a number of pronouncements, including the STI Act (South Africa, 1998), IFRS 4 issued by the IASB (2004), Circular 2/2007 issued by SAICA (2007), and APN 401 issued by ASSA (2013). These publications will be discussed in relation to their application to the accounting for short-term insurance contracts.

Chapter 3 – Accounting for short-term insurance contracts under IFRS 17.

This chapter describes the PAA under IFRS 17 and its application to short term insurance contracts.

Chapter 4 – Assessment of IFRS 17's requirements

This chapter assesses the changes from the current accounting model to the IFRS 17 PAA model for short-term insurance contracts.

Chapter 5 – Conclusions

This chapter summarises the research findings and provides recommendations for further research.

Chapter 2. Current accounting model

2.1 Introduction

This chapter describes the current accounting model applied to short-term insurance contracts in South Africa. As highlighted in the previous chapter, local GAAP authoritative guidance for short-term insurance contracts consists of IFRS 4 issued in 2004 (IASB, 2004) and Circular 2/2007 issued in 2007 (SAICA, 2007). In addition to IFRS 4 and the Circular, short-term insurers also comply with the STI Act's regulatory reporting requirements. These requirements include the prescribed methods of determining the Unearned Premium Provision (hereafter UPP) and Incurred But Not Reported (hereafter IBNR) claims in accordance with the Board Notice issued in 2011 and APN 401 issued in 2013. The determination of UPP and IBNR are important for the purpose of financial reporting of short-term insurance. Figure 2.1 outlines the current accounting model for short-term insurance contracts in South Africa.

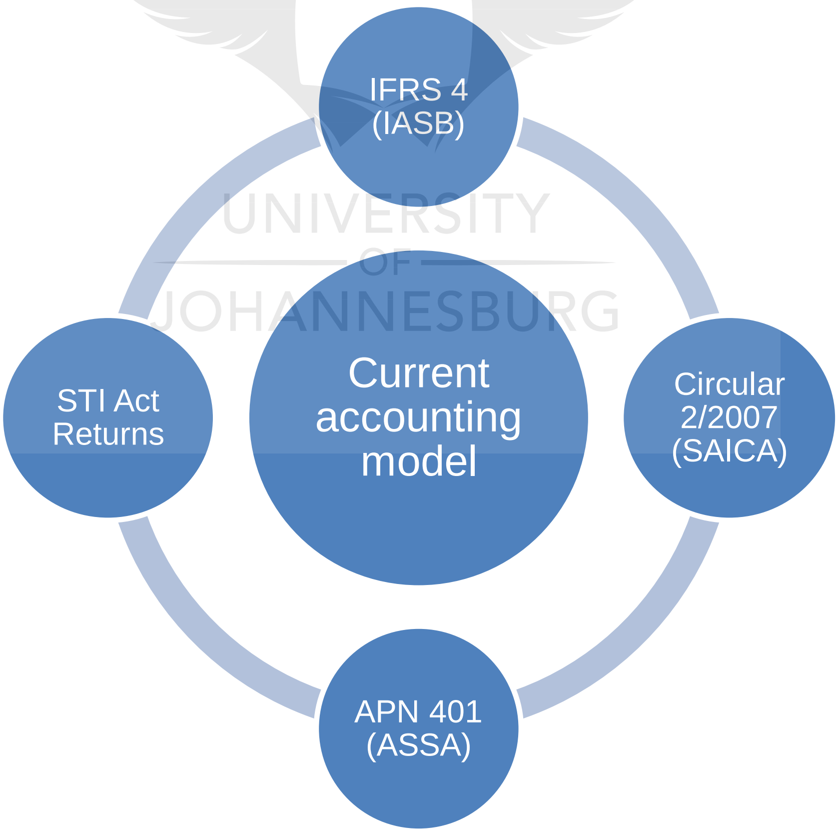

Figure 2.1: Current accounting model

Source: Own construction

APN 401 was issued to provide guidance on compliance with the STI Act, therefore the requirements of APN 401 and the STI Act are similar, which prescribe the regulatory reporting aspects of short-term insurance. Table 2.1 provides a comparison of terms used in APN 401, Circular 2/2007 and IFRS 4.

Table 2.1: Short-term insurance terminology comparison.

STI Act / APN 401	**Circular 2/2007**	**IFRS 4**
Premium provisions • Unearned Premium Provision (UPP) (ASSA, 2013: para. 3.1.3).	Unearned Premium Provision (UPP) (SAICA, 2007: para. 23).	Insurance liability • Unearned premiums (IASB, 2004: para. IG22a).
Claim provisions • Case estimates; • Estimate for future development (Incurred but not enough reported); • IBNR claims; • Profit commissions; • Claims handling expenses. (ASSA, 2013: para. 3.2.3).	Provision for outstanding claims; and IBNR Claims. (SAICA, 2007: para. 29–37).	Insurance liability • Reported claims, • IBNR (IASB, 2004: para. IG22b and c).
Unexpired risk reserve (ASSA, 2013: para. 3.2.6).	Unexpired risks provision Liability adequacy (SAICA, 2007: para. 38–47).	Onerous Contracts Liability, or Liability adequacy adjustment (IASB, 2004: para. B7c).

Source: Own construction

2.2 Overview of the South African regulatory environment

South African short-term insurers are required to comply with two reporting regimes, namely financial reporting and regulatory reporting. South African insurers are all required to be public companies and to comply with the Companies Act, hence the Companies Act is relevant to the financial reporting of insurers. Financial reporting for short-term insurance in South Africa is regulated by two statutes, namely the Companies Act 2008 and the STI Act 1998. The STI Act (South Africa, 1998:sec. 69) requires the financial statements of a short-term insurer to be prepared and presented in accordance with IFRS. According to the STI Act, only public companies with the main objective of conducting short-term insurance business qualify for registration as insurers (South Africa, 1998: sec. 9(3)). In terms of the Companies Act, the reporting framework applicable to public companies is IFRS (South Africa, 2008: sec. 29(5)).

The regulatory reporting requirements for short-term insurers are set out in the STI Act (South Africa, 1998: sec. 35). The FSCA is the market conduct regulator of financial institutions in South Africa. These financial institutions provide financial products and financial services, and include financial institutions that are licensed in terms of a financial sector law. Such institutions include banks, insurers, retirement funds and administrators, and market infrastructures. The FSCA is responsible for market conduct regulation and supervision (FSCA, 2019). The FSCA established the regulatory reporting principles for insurers, who are required to file quarterly and annual regulatory returns.

2.2.1 Financial reporting

Since all South African insurance entities are public companies, although some are not listed on the Johannesburg Stock Exchange (hereafter JSE), they are all required to prepare their financial statements in accordance with IFRS. Thus, when IFRS 4 was issued in 2004, it became mandatory for short-term insurers to apply IFRS 4 in accounting for their insurance contracts.

In terms of the JSE Listing Requirements (JSE, 2017: sec. 8.3 and 8.62b), the annual financial statements of a listed entity should be prepared in accordance with IFRS and the SAICA Financial Reporting Guides and Financial Pronouncements issued by the Financial Reporting Standards Council (hereafter FRSC). The relevant financial reporting guide issued by SAICA that must be applied by short-term insurers is Circular 2/2007.

Due to the fact that IFRS 4 does not provide sufficient valuation guidance for determining certain insurance liabilities, the actuarial valuations performed for regulatory reporting purposes provide useful guidance on the measurement of a short-term insurer’s insurance liabilities.

2.2.2 *Regulatory reporting*

In terms of the STI Act, the registrar of short-term insurers requires every insurer to furnish the registrar with returns relating to its business (South Africa, 1998: sec. 35). These returns are various customised reports in which the insurer is required to provide certain financial and solvency information required by the FSCA, which should be submitted to the registrar of short-term insurers on a quarterly and annual basis. This information includes, for example, details of classes of business underwritten, reinsurance information, financial information, information about office bearers etc. The registrar also requires insurers to submit their financial statements together with their insurance returns, and to reconcile the amounts in these two sets of reports.

Part IV of the STI Act deals with the financial arrangements for short-term insurers. These include requirements for the maintenance of a financially sound condition. This section focuses on the prescribed kinds and the spread of assets for short-term insurers, as well as the requirement to determine insurance liabilities (South Africa, 1998: sec. 28–34). The effect of the asset spreading is that insurers of short-term contracts are required to spread their investments over a number of asset categories in order to reduce concentration risk on a particular class of assets, and to match the liability profile of the insurer. The percentages permitted differ according to the risk profile of the investment products held (FSCA, 2015).

In accordance with Sections 29, 30 and 32 of the STI Act, Schedule 2 of the Act prescribes the requirements for determining the values of a short-term insurer's assets and liabilities for the purpose of regulatory reporting. This Schedule was replaced by the Board Notice in October 2011 (South Africa, 2011). The purpose of the Board Notice is to prescribe the requirements for the valuation of assets, liabilities and the determination of the capital adequacy of a short-term insurer.

The valuation of insurance liabilities is sometimes a complex exercise due to the level of expertise and judgement required and the estimation methods applicable to these valuations. Most insurers employ the services of actuaries, who are members of ASSA, to perform these valuations. ASSA requires its members to comply with the requirements of APN 401 when they estimate an insurer's insurance liabilities, described as "technical provisions" in APN 401. These technical provisions should be valued in accordance with the requirements set out in the Board Notice (ASSA, 2013: para. 3.1.2).

In the next section, the application of IFRS 4 to short-term insurance contracts is analysed in detail.

2.3 IFRS 4 Insurance Contracts

IFRS 4 was issued by the IASB in 2004 as a starting point for the development of a comprehensive insurance financial reporting standard. IFRS 4 identifies and defines insurance contracts, requires an entity to perform a liability adequacy test and describes disclosures required for insurance contracts. The standard does not cover the recognition and measurement of insurance contracts in detail but instead permits insurers to continue applying their existing accounting policies. In limited circumstances, an insurer is permitted to change those existing accounting policies. The following measures were introduced in IFRS 4 to cater for the continuation of existing policies and to provide for limited changes in those accounting policies (IASB, 2004):

- Providing for a temporary exemption from applying the hierarchy of developing accounting policies in IAS 8;
- Limiting the impact of this deviation from IAS 8 by introducing specific insurance accounting requirements relating to liability adequacy, catastrophe provisions, offsetting and impairment of reinsurance assets and derecognition; and
- Allowing certain accounting practices in use by insurers to continue, but not allowing insurers to introduce the same practices if they previously did not apply them (IASB, 2004: BC78).

Due to the fact that there were diverse accounting practices across entities and jurisdictions, IFRS 4 was issued with the following objectives (IASB, 2004):

- As Phase I of the insurance project to introduce limited improvements to insurance accounting practices; and
- To prescribe disclosures for insurance contracts from the insurer’s financial reporting perspective.

The next section highlights the recognition and measurement requirements of IFRS 4.

2.3.1 Recognition and measurement of short-term insurance contracts

Since IFRS 4 does not address recognition and measurement in any detail, the standard permits insurers to continue applying their existing recognition and measurement practices until the completion of Phase II of the insurance project (IASB, 2004). Below are IFRS 4's requirements for recognition and measurement of all insurance contracts.

Temporary exemption from applying IAS 8

Because of the recognition and measurement gap in IFRS 4, entities were supposed to apply paragraphs 10 to 12 of IAS 8 to develop accounting policies for the recognition and measurement of insurance contracts. However, IFRS 4 exempts insurers from applying the IAS 8 requirements relating to the selection of accounting policies for the recognition and measurement of insurance contracts (IASB, 2004: para. 13).

Continuation of existing accounting practices

Due to the temporary exemption from applying IAS 8, insurers are allowed to continue with their existing accounting practices until IFRS 17 becomes effective. If an insurer followed any of the accounting practices listed below prior to the issuing of IFRS 4, IFRS 4 allows their continuation. However an insurer that had not previously adopted the following practices was not allowed to introduce them after adopting IFRS 4 (IASB, 2004: para. 25):

- Measuring insurance contracts at undiscounted values;
- Using non-uniform accounting policies for subsidiaries, unless changing those policies does not result in more diversity in accounting for insurance contracts; and
- Measuring contractual rights to future investment management fees at an amount that exceeds their fair value.

2.3.2 Unbundling of deposit components

Generally, insurance contracts that require advance premium payments contain deposit elements. IFRS 4 defines a deposit component as a contractual component that is not accounted for as a derivative under IFRS 9 and would be within the scope of IFRS 9 if it were a separate instrument (IASB, 2004: Appendix A).

In terms of IFRS 4, an entity should unbundle the deposit component and account for it in terms of IAS 39 or IFRS 9 when the following conditions are met (IASB, 2004: para. 10a):

- The deposit component can be measured, and
- The entity does not have accounting policies that require it to recognise the deposit component separately from the insurance component.

In terms of IFRS 4, if the entity's accounting policies do not require it to recognise the rights and obligations from the deposit component, the entity could omit material assets or liabilities from the financial statements if it does not unbundle and account for the deposit component separately (IASB, 2004: para. BC45). This occurs for example when an entity's accounting policies require it to recognise all received premiums as revenue, even if some of those premiums may be repayable in future.

Under these circumstances, an insurer should unbundle the guaranteed refund component so that it accounts for this component separately from the insurance component (IASB, 2004: para. 10). The accounting consequence is the recognition of a deposit liability, which would otherwise not have been recognised because the entity's accounting policies permit the recognition of all premiums as revenue. Although 'no claim bonuses' are common in South Africa, the available accounting guidance does not specifically address the accounting treatment of these bonuses.

According to Ernst & Young (2013), clauses that guarantee that the policyholder will be refunded some of the insurance premiums indicate the need for unbundling. These clauses include 'no claim bonuses', 'profit commissions' or 'claims experience clauses' (.*ibid*). In South Africa, no claim bonuses, also known as cash back bonuses according to the VAT 421 Guide for short-term insurance (SARS, 2013), are common. The guide describes a 'no claim bonus' as an amount that is paid to the insured as a result of that person not making any claims on the policy over a specified period of time. It therefore appears that 'no claim bonuses' or 'cash back bonuses' can be accounted for as deposit components under IFRS 4. This is the approach followed in the regulatory returns which require cash back bonuses to be a component of UPP (FSCA, 2015), an insurance liability.

If the entity's accounting policies already require it to recognise the rights and obligations from the deposit components, unbundling is permitted but is not a requirement in terms of IFRS 4 (IASB, 2004: para. 10b). This is because the accounting policies require some form of liability to be recognised for the deposit component, regardless of whether unbundling is specifically required. Unbundling is not permitted if the deposit component cannot be measured (IASB, 2004: para. 10c).

The premiums allocated to the unbundled deposit component should be accounted for as changes in the deposit liability instead of revenue (IASB, 2004: para. 41c). If material, IFRS 4 requires the portion of transaction costs that relate to the deposit component to be allocated to that component (IASB, 2004: para. 41d). Additionally, an accounting mismatch could arise from the unbundled component because financial liabilities are measured at fair value or amortised cost under IFRS 9 (IASB, 2014: para. 4.2.1), which differ from the IFRS 4 which does not specify the measurement model of insurance liabilities (IASB, 2004: para. BC41). Cash back bonuses are estimates, and the changes in those estimates can result in the adjustment of both the deposit and the insurance components. The measurement mismatches between the two components can result in diverse accounting practices.

2.3.3 Revenue recognition

Because of its limited recognition and measurement guidance, IFRS 4 (IASB, 2004: para. IG25) refers to the IAS 18 disclosure requirements for revenue, without prescribing that insurers should follow the IAS 18 requirements for revenue recognition. The implementation guidance identifies three methods of revenue recognition that exist in practice (IASB, 2004):

- Recognition of earned premiums as revenue and incurred claims, including estimates of IBNR claims, as expenses;
- Recognition of premiums received as revenue, and an expense relating to the increase in insurance liabilities; and
- Recognising premiums received as deposits, and revenue earned is determined with reference to charges for items such as mortality.

The existing accounting practice for short-term insurance is based on the first option under IFRS 4 paragraph IG25. This option is prescribed in Circular 2/2007, which requires the recognition of gross written premiums in the income statement (refer to section 2.4.2 for a detailed discussion of written premiums), and an adjustment of this amount for the movement in the unearned premiums balance to arrive at the net earned premiums revenue (SAICA, 2007: para. 16 and 21). The unearned premiums adjustment can either be an increase or decrease in revenue, depending on how the unearned premiums balance changes. This unearned premiums balance represents deferred revenue. If this balance increases, the increase is recognised as a reduction of gross written premiums and therefore as an expense. Conversely, if the unearned premiums balance decreases, revenue is increased with the same amount of the reduction in the unearned premiums balance.

2.3.4 Changes in accounting policies

IFRS 4 permits limited changes to an entity's existing accounting policies for insurance contracts. These changes are discussed below.

Relevance and reliability

In terms of IFRS 4, if an entity changes its existing accounting policies for the recognition and measurement of insurance contracts, that change is required to satisfy the relevance and reliability criteria required in terms of IAS 8 (IASB, 2004: para. 22). An insurer is allowed to change its accounting policies for the valuation of its designated insurance liabilities to reflect current market interest rates and to recognise the changes in those liabilities in profit or loss. Additionally, the insurer is allowed to introduce accounting policies that require other current estimates and assumptions for the designated liabilities (IASB, 2004: para. 24).

Prudence

In terms of IFRS 4, an insurer is not required to change its accounting policies for insurance contracts to eliminate excessive prudence when measuring insurance contracts (IASB, 2004: para. 26). Although the IASB noted the concern regarding lack of neutrality if amounts are measured with excessive prudence, when IFRS 4 was issued the board had not yet decided how much prudence was appropriate for inclusion in the measurement of insurance contracts. Consequently, entities are allowed to continue measuring insurance contracts with excessive prudence if they had already adopted this measurement approach before adopting IFRS 4. However, insurers are prohibited from introducing additional prudence if they had already measured their insurance liabilities with sufficient prudence (IASB, 2004: para. 26 & BC133).

2.3.5 Other specific accounting requirements of IFRS 4

IFRS 4 has specific accounting requirements for insurers which include certain valuation, presentation and derecognition principles to be applied to all insurance contracts an insurer issues. An insurer is required to:

- perform a liability adequacy test,
- perform an impairment test on reinsurance assets; and
- derecognise insurance contract liabilities only when the contract expires, is cancelled or is fully discharged (IASB, 2004: para. 14).

When IFRS 4 was issued, the derecognition of insurance liabilities was aligned to the derecognition requirements of financial liabilities in terms of IAS 39 (IASB, 2004: para. BC105).

The following accounting practices are not permitted by IFRS 4 (IASB, 2004: para. 14):

- Offsetting when accounting for reinsurance contracts; and
- Recognising liabilities for possible future claims but before they occur.

Liability adequacy test

In terms of IFRS 4 (IASB, 2004: Appendix A), a liability adequacy test should be conducted to assess whether or not the carrying amount of an insurance liability needs to be increased, or the carrying amount of related deferred acquisition costs (hereafter DAC) or related intangible assets needs to be decreased. This assessment should be based on a current review of future cash flows under the insurance contract. This exercise tests the sufficiency of recognised liabilities and valuation of insurance contract assets of an insurer at the reporting date, and is applicable to all forms of insurance contracts including short-term contracts.

According to IFRS 4, an insurer is required to perform an assessment of the adequacy of its recognised insurance liabilities. This assessment should be performed using current estimates of recognised insurance contracts. The standard requires adjustments to the contractual liabilities at the remeasurement date to be recognised in profit or loss (IASB, 2004; Lindberg & Seifert, 2010).

Reinsurance

According to IFRS 4, a reinsurance contract is an insurance contract issued by one insurer to compensate another insurer for losses on one or more insurance contracts issued by the direct insurer (IASB, 2004: Appendix A). Under this type of insurance contract, the insurer is called a reinsurer and the policyholder a cedant (IASB, 2004). IFRS 4 does not permit offsetting reinsurance assets against direct insurance liabilities (IASB, 2004: para. 14d). Similarly, offsetting of income and expenses from reinsurance contracts against expenses and income from direct insurance contracts is not permitted. When the reporting entity issues reinsurance contracts, income and expenses from the reinsurance contracts should be accounted for in the same way as other insurance contracts the entity issues directly to policyholders.

IFRS 4 requires a cedant to perform an annual impairment assessment on reinsurance assets (IASB, 2004: para. 20). Impairment indicators for reinsurance assets relate to objective evidence that the cedant may not receive all amounts owed under the reinsurance contract resulting from events that occurred after initial recognition of the reinsurance contract. The impact of such events should be reliably measurable for the cedant to recognise the impairment loss.

Shadow accounting

According to principles established in IFRS 4, shadow accounting is an accounting approach that enables an insurer to adjust its aggregate insurance liabilities in order to reduce accounting mismatches. These accounting mismatches arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements and realisation of those gains and losses would have a direct effect on the measurement of insurance liabilities (IASB, 2004). If the measurement of insurance liabilities is not directly affected by gains or losses on underlying assets, the reporting entity is not permitted to apply shadow accounting (IASB, 2004: para. IG9).

IFRS 4 (IASB, 2004: para. 30) provides insurers with an accounting policy choice that allows them to apply shadow accounting. Shadow accounting is applicable when:

- realised or unrealised gains and losses on assets affect the measurement of insurance liabilities, related deferred acquisition costs and intangible assets; and
- the unrealised gains and losses on the assets are recognised in other comprehensive income (hereafter OCI).

If the two requirements above are applicable, IFRS 4 permits the resulting adjustments to the insurance liabilities.

Hence, when there is a contractual linkage between payments to policyholders and the returns from underlying assets, shadow accounting may be relevant. In terms of IFRS 4, shadow accounting is an accounting policy choice rather than a requirement. When IFRS 4 was issued, the IASB was of the view that this practice would be phased out and Phase II of the insurance project would not contain shadow accounting, both as a requirement or an accounting policy choice (IASB, 2004: para. BC183–184).

Insurance contracts with discretionary participation features

In 2004 the IASB introduced insurance contracts with discretionary participation features in IFRS 4 (IASB, 2004). Insurance contracts that entitle policyholders to receive additional benefits in addition to guaranteed benefits contain participation features. This usually involves participation in the insurer's profits for the specific portfolio of insurance contracts or the unrealised returns from designated underlying investments. If the amount or timing of these additional benefits is at the discretion of the insurer, the benefits become discretionary (IASB, 2004).

IFRS 4 does not require an entity to unbundle the guaranteed and discretionary components of an insurance contract in order to account for them separately (IASB, 2004: para. 34(a)). If the insurer does not separate the guaranteed element from the contract, the whole contract should be classified as an insurance liability. If the entity separates the two components, the guaranteed element should be classified as an insurance liability. The changes in the liability should be recognised in profit or loss, together with the premiums received on the contract. The discretionary portion should be treated as a separate component of equity, with an appropriate allocation of profits or losses in the statement of comprehensive income in the same way non-controlling interests are allocated profits in a group situation (*ibid.*).

2.3.6 Application of IFRS 4 to certain financial instruments

IFRS 4 applies to investment contracts with discretionary participation features and financial guarantee contracts that are in the scope of the standard. Additionally, the standard has requirements for the redesignation of financial instruments if certain requirements are met.

Investment contracts with discretionary participation features

Financial instruments with discretionary participation features are in the scope of IFRS 4 (IASB, 2004: para. 2b). Generally, the same requirements applicable to insurance contracts with a discretionary participation feature apply to these financial instruments, but with additional requirements. If the entity classifies the discretionary participation feature in the investment contract as a liability, IFRS 4 requires the liability adequacy test to be performed on both the liability and discretionary components. If the entity classifies a component of the contract as equity, the liability relating to the guaranteed component should be measured in accordance with IFRS 9: *Financial Instruments* (IFRS 9) (IASB, 2004: para. 35). The distributions to policyholders should be treated as an allocation of profits, in the same manner non-controlling interests are allocated a share of profits in group financial statements (IASB, 2004: para. 34).

Although IFRS 4 contains guidance on the accounting treatment of investment contracts with discretionary participation features, many South African short-term insurers might not have issued such contracts due to the local insurance legislation.

Financial guarantee contracts

Financial guarantee contracts are insurance contracts that provide cover to holders of financial instruments if specified debtors default on amounts owed (IASB, 2004). IFRS 4 states that financial guarantee contracts fall within the scope of the financial instruments standards. Insurers who previously accounted for such contracts as insurance contracts can elect to continue to account for them as insurance contracts or as financial instruments. However, first time issuers of financial guarantee contracts are required to apply IAS 32, IFRS 7 and IFRS 9 to account for these contracts (IASB, 2004: para. 4d).

In terms of the STI Act, a guarantee policy is a contract in terms of which a person, other than a bank, undertakes to provide policy benefits if a holder of a contract fails to discharge an obligation. These policy benefits are provided in return for insurance premiums in terms of the contract. The definition of a short-term insurance contract includes a guarantee policy (South Africa, 1998: sec 1xv).

Redesignation of financial instruments

IFRS 4 permits an insurer to change accounting policies if the changes make the financial statements more relevant and reliable to the economic decision-making needs of users (IASB, 2004: para. 22). If an insurer changes accounting policies to remeasure its insurance liabilities at current market rates and those changes are recognised in profit or loss (IASB, 2004: para. 24), the entity is allowed to reclassify its financial instrument to fair value through profit or loss (IASB, 2004: para. 45). This reclassification should be treated as a change in accounting policy.

2.3.7 Presentation

IFRS 4 provides the following limited presentation guidance for insurance contracts (IASB, 2004: para. 14d):

- Offsetting reinsurance assets against the direct insurance liabilities is not permitted, and
- Offsetting income or expense from reinsurance contracts against expenses or income from the direct insurance contracts is not permitted.

Other presentation requirements described in IFRS 4 include shadow accounting, expanded presentation of the fair value of insurance contracts acquired in a business combination and presentation of insurance contracts with participating features. When an entity applies shadow accounting, it has an accounting policy choice to recognise certain remeasurement adjustments in OCI.

Statement of comprehensive income

Although IFRS 4 does not prescribe any minimum information requirements to be presented in the statement of comprehensive income, reference is made to the minimum information requirements of IAS 1: *Presentation of Financial Statements* (hereafter IAS 1) (IASB, 2007: para. 82). The implementation guidance in IFRS 4 suggests that the following amounts should be presented in order to comply with IAS 1 (IASB, 2004: para. IG24):

- insurance revenue (not adjusted by reinsurance premiums),
- reinsurance income,
- claims incurred (not adjusted by reinsurance claims recoveries), and
- reinsurance expenses.

The requirements of IFRS 4 above are consistent with the existing accounting model in terms of the regulatory returns. The items listed above also form part of the FSCA's return, presented in Table 2.5 under the FSCA section.

Statement of financial position

In conforming to IAS 1 and IFRS 4, insurers should present the following items separately in their statements of financial position (IASB, 2007: para. 77 & 78; IASB, 2004: para. IG20 & 22):

- gross insurance liabilities, comprising unearned premium liabilities and claims liabilities; including IBNR, for all insurance and reinsurance contracts an entity issues,
- assets under insurance (and reinsurance) contracts an entity issues, and
- assets or recoveries under reinsurance contracts held.

These items are also part of the existing accounting model on short term insurance in terms of the structure and content of the statement of financial position for regulatory reporting purposes. These presentation structures are discussed under section 2.6.1.

Self – insurance

According to IFRS 4, self-insurance does not give rise to insurance contracts as defined in IFRS 4 because there is no transfer of significant risk from one party to another (IASB, 2004: para. B19b). Self – insurance is when one entity within a group of companies issues insurance contracts to other entities within the group, but does not issue contracts to any entities outside the group. Holly and Greszta (2016) describe self-insurance as follows:

> "The essence of self – insurance is that a business entity that faces a potential loss to its own assets and / or business interruption as a result of an unexpected, sudden and accidental event or when it may become liable due to a negligent act and decides to 'carry the risk' on its own or within an organized group of people or companies, i.e. group captives, rather than to conclude an insurance agreement with commercial insurance companies" (Holly & Greszta, 2016:54).

Hence, from a group reporting perspective, there is no transfer of significant insurance risk from one party to the other (IASB, 2004: para. B19c) and therefore no insurance contract as defined in IFRS 4. In a group situation, if one group entity issues insurance contracts to other group entities, the contracts should be treated as insurance contracts in the separate financial statements of the insurer, but eliminated on consolidation. If the intragroup insurance contracts are reinsured with a third party reinsurer, the reinsurance contracts should be treated as direct insurance contracts at group level (IASB, 2004: para IG2).

2.3.8 Disclosure

IFRS 4 has two broad disclosure principles for insurance contracts, namely the explanation of recognised amounts, and the nature and extent of risks arising from insurance contracts. The first principle, the explanation of recognised amounts, requires an insurer to disclose the significant assumptions employed in determining recognised amounts, as well as the changes in those assumptions. It also requires disclosures about changes in insurance liabilities. These changes should take the form of reconciling the opening and closing balances of insurance liabilities, reinsurance assets and deferred acquisition costs. The standard also requires the disclosure of accounting policies, amounts recognised in the statements of financial performance, and explanations of those amounts, for example premiums, claims, acquisition costs and gains or losses on portfolio transfers (IASB, 2004: para. 37).

Secondly, IFRS 4 requires the disclosure of information about the nature and extent of risks arising from insurance contracts in its financial statements (IASB, 2004: para. 38). For example, an insurer should disclose information about the insurance risk, before and after risk mitigation by way of reinsurance. The disclosures about insurance risk should also incorporate sensitivity to insurance risk and concentrations of the insurance risk. IFRS 4 requires disclosures about the entity's claims development. Claims development is the comparison of actual claims to previous estimates set aside for these claims. However, disclosures about claims that are typically settled within one year are not required (IASB, 2004: para. 39).

The last set of disclosures required by IFRS 4 pertaining to the 'nature and extent of risks' are derived from IFRS 7 *Financial Instruments – Disclosures* (IFRS 7). An insurer is required to provide disclosures about credit risk, liquidity risk and market risk that are consistent with the requirements of IFRS 7. These disclosures include the maturity analysis of insurance liabilities and a sensitivity analysis of profit and equity to certain risks. Quantitative disclosures should include the analysis of how profit and equity would have changed if a relevant risk variable had occurred at the reporting date. Qualitative disclosures should include information about the terms and conditions that have a material effect on an insurer's future cash flows arising from recognised insurance contracts (IASB, 2004: para. 39 and 39A).

2.4 SAICA's Circular 2/2007

As discussed above, IFRS 4 allows insurers to continue applying their existing accounting policies for insurance contracts, except when the standard permits changing these policies in accordance with paragraph 22 (IASB, 2004). South Africa's existing practices for insurance contracts accounting were established by SAICA. SAICA issued the *Accounting Guide on Short-Term Insurance* in 2001 and replaced it with Circular 2/2007 in 2007.

Before adopting IFRS in 2005, South African entities applied SA GAAP in the preparation and presentation of financial statements. Where SA GAAP did not adequately address an accounting issue, SAICA issued supplementary accounting guides and circulars to address these issues. One such area for which SAICA issued a guide is the accounting requirements for short-term insurance. SAICA issued Circular 2/2007 in order to provide a point of reference for the recognition and measurement of short-term insurance contracts. It provides recognition and measurement guidance on the following accounting aspects of short-term insurance:

- annual basis of accounting;
- premiums;
- claims;
- liability adequacy;
- unexpired risks provisions; and
- commission.

With the exception of the liability adequacy requirements of the Circular, each one of these sections is discussed below. Consistent with the requirements of IFRS 4 (IASB, 2004: para. 15) discussed under 2.3.4, the Circular requires an insurer to perform a liability adequacy test at each reporting date, and the accounting requirements are the same under both IFRS 4 and Circular 2/2007.

2.4.1 Accounting basis

The Circular (SAICA, 2007) identifies two bases of accounting: the fund basis and the annual basis. In terms of the Circular, insurers may not use the fund basis of accounting (SAICA, 2007: para. 07). Consequently that basis is not discussed in this section.

Annual basis of accounting

Under the annual basis, the underwriting result disclosed in the financial statements is determined at the end of the reporting period. It reflects the profit or loss from conducting insurance underwriting business during the reporting period. The underwriting result incorporates necessary adjustments to claims and premium estimates, in order to reflect the most recent underwriting experience in the reported profit or loss. Circular 2/2007 requires insurers to adopt the annual basis of accounting (SAICA, 2007).

2.4.2 Premiums

This section describes the Circular's accounting requirements for gross written premiums, earned premiums and reinsurance premiums.

Gross written premiums

Circular 2/2007 requires the recognition of gross written premiums at the beginning of the coverage period. Gross written premiums is an amount that comprises all the premiums for all policies incepted during the underwriting period, regardless of when the cash flows fall due for collection (SAICA, 2007: para. 11 and 16). These premiums are for the entire coverage period for which the insurer accepts the insurance risk.

Recognition of insurance premium receivables

When an insurance broker performs underwriting and premium collection activities on behalf of the insurer, the premiums paid over to the insurer are generally paid net of commission. Commission is the broker's compensation for conducting these activities on behalf of the insurer. The insurer should account for the gross written premiums separately from the commission, regardless of receiving the net amount from the broker (SAICA, 2007: para. 13). If, at the end of the reporting period, there are premiums that were collected by the broker and not yet paid over to the insurer, the insurer should raise an accounts receivable for those outstanding balances.

These receivables should comprise only net premiums already collected in cash by the broker. According to the Circular, when the insurer recognises renewal premiums without confirmation by the policyholder, written premiums should be adjusted for anticipated lapses and cancelations for amounts that may not be received from the recognised contracts (SAICA, 2007: para. 18).

Earned premiums

When gross written premiums for the entire coverage period are recognised at contract inception, insurers recognise an asset (bank or receivable), together with an unearned premiums liability. The unearned premiums are premiums that are allocated to other reporting periods, where the coverage period of the contract ends after the reporting date. The unearned premiums are an insurance liability commonly referred to as the UPP. Earned premiums are the revenue that relates to the insurance services provided by the insurer to the policyholders during the reporting period.

Hence, premiums written during a reporting period should be adjusted for the changes in the UPP balance to arrive at the earned premium revenue. According to the Circular, premium revenue should be recognised evenly over the coverage period, or in accordance with the pattern of the incidence of risk, whichever is more appropriate (SAICA, 2007: para. 22).

Reinsurance Premiums

Reinsurance inwards refers to premiums received by an insurer on insurance contracts issued to other insurers. Reinsurance outwards refers to insurance premiums paid to issuers of reinsurance contacts by cedants. A cedant is a policyholder under a reinsurance contract (IASB, 2004: IFRS 4 Appendix A). These premiums should be recognised as expenses when incurred (SAICA, 2007).

Revenue recognition for reinsurance inwards is similar to the revenue recognition of the underlying / direct insurance contacts described in the previous section. The reinsurer should defer revenue for reinsurance premiums received in respect of future periods or unexpired risks. For example, when the reinsurance coverage period does not coincide with the reporting period of the entity, reinsurance premiums recognised in the current reporting period might include premiums for other reporting periods, giving rise to reinsurance UPP. In terms of the Circular, the pattern of revenue recognition for proportional reinsurance should be consistent with the revenue recognition for the reinsured direct insurance policies. For non-proportional reinsurance, reinsurance revenue is presumed to be earned evenly over the period of cover (SAICA, 2007: para. 25).

2.4.3 Claims

The Circular requires an insurer to recognise claims as expenses during the periods in which the claims are incurred. In some instances, there are uncertainties regarding the timing or amount of the incurred claims. In these instances, the reporting entity estimates the amounts it expects to use to compensate policyholders. These estimates comprise both reported and unreported incidents that occurred up to the reporting date. Sometimes insurers estimate the cost of reported incidents in processes that involve complex estimations, which may involve using the services of loss assessors or estimators.

An entity should develop estimation methodologies for unreported claims based on appropriate statistical and other techniques incorporating any expected time delay in reporting claims. Payments for claims included in the unpaid claims estimate reduce the amount of the claims liability (SAICA, 2007). Differences between estimates and actual payments (experience adjustments) should be recognised in profit or loss. Additionally, an entity should recognise claims recoveries in profit or loss (SAICA, 2007: para. 35). These recoveries take the form of either reinsurance claims or salvage. The substance of these recoveries is the reduction of gross incurred claims.

The Circular requires an insurer to estimate anticipated claims handling costs for recognised insurance contract liabilities (SAICA, 2007: para. 36). This estimate forms part of outstanding claims at the end of the reporting period. Claims handling costs are the indirect costs of assessing and settling reported claims (SAICA, 2007: para. 37). Paragraph 37 requires an insurer to estimate future claims handling expenses relating to recognised outstanding claims at the reported date and to recognise a provision for these claims handling expenses based on the historical proportion of the claims handling expenses to the outstanding claims liability.

2.4.4 Unexpired risks provision

In terms of the Circular and APN 401, if the expected value of claims and expenses attributable to the future periods of the recognised insurance contracts at the reporting date exceeds the UPP attributable to those policies, the insurer should assess the need for the recognition of an unexpired risks provision (SAICA, 2007; ASSA, 2013). An insurer is permitted to incorporate the future investment returns on investments supporting the UPP at the reporting date when determining the adjustment required for the unexpired risk provision (SAICA, 2007: para. 44).

When determining the unexpired risk provision, the amount should take into account the adjustment already made under the liability adequacy test, to avoid double counting. The expected value of future claims should be determined on the basis of historical experience of similar contracts in the past year. In the absence of historical data on which to base the projections, APN 401 requires the formulation of data relationships by consulting with people responsible for the estimates (ASSA, 2013: para. 3.7.1).

The requirement to determine the unexpired risk provision is established by the Board Notice. In terms of the Board Notice, an insurer should consider creating an unexpired risk provision if it makes an underwriting loss during the reporting period (South Africa, 2011: sec 4.4). An underwriting loss is an operating loss from conducting short-term insurance business. The purpose of the provision is to defray the possible cost of claims and costs of conducting the short-term insurance business (*ibid.*).

If the liability adequacy test required in terms of IFRS 4 is performed properly, there should be no need to determine the unexpired risk provision required by the Board Notice, as both tests seek to establish the adequacy of the recognised insurance liabilities. Notably, the Circular requires both the liability adequacy test to be performed and the unexpired risk provision to be determined. This may be a case of excessive prudence in the measurement of insurance liabilities according to the Circular.

2.4.5 Commission

Commission or acquisition costs are charged by agents for conducting business on behalf of the principal (the insurer or underwriter). An insurer should recognise the commission incurred on acquisition of insurance contracts separately from premium revenue, despite net settlement by intermediaries. Similar to the pattern of premium revenue recognition, an insurer should recognise commission over the risk period relating to the underlying insurance contract. In terms of the Circular, the proportion of commission that is deferred represents DAC (SAICA, 2007), an asset.

Similarly, reinsurance commission should be deferred in line with reinsurance premium expenses, a principle similar to matching revenues and expenses in the statement of comprehensive income, and recognising residuals in the statement of financial position (Wüstemann & Kierzek, 2005). In some instances, insurers enter into profit sharing arrangements with reinsurers. An insurer recognises profit commission when it becomes probable that they will receive the cash flows under the participating contract.

Circular 2/2007 permits an entity to defer commission to future periods in the form of DAC (SAICA, 2007: para. 48), and to amortise the DAC over the estimated coverage period in proportion to the recognised premium revenue (Mulford & Parkhurst, 2010). Brokers' commission is generally capitalised based on invoiced amounts, and written off over the coverage period of the new contract or the renewal period. DAC is generally capitalised based on amounts incurred for groups of insurance contracts, without the need to specifically identify costs relating to each individual contract.

2.4.6 Profit commission

Insurance contracts that include profit commissions contain direct participation features. IFRS 4 does not contain specific guidance on the accounting treatment of profit commissions. However, Circular 2/2007 requires the recognition of profit commissions when they are measurable and likely to be realised (SAICA, 2007: para. 50).

2.5 Board Notice 169 of 2011 and APN 401 – Technical provisions

The measurement guidance for insurance liabilities in APN 401 is based on the requirements of the STI Act and the Board Notice (ASSA, 2013). APN 401 is relevant to the accounting for short-term insurance contracts because the amounts derived from valuations performed in terms of the practice note are used in financial reporting. ASSA issued the practice note, APN 401 in 2013 to guide actuaries in performing the valuation of insurance liabilities for the purposes of regulatory reporting, independent valuations or financial reporting.

Even though entities can choose to adopt actuarial valuations performed in accordance with APN 401 for the purposes of financial reporting, the practice note states that valuation techniques for financial reporting should be in accordance with IFRS 4 and Circular 2/2007 (ASSA, 2013: para. 2). Notably, IFRS 4 and Circular 2/2007 do not provide any valuation guidance for insurance liabilities.

According to APN 401, technical provisions are the amounts set aside to meet all liabilities arising from insurance contracts (ASSA, 2013). These amounts include:

- claims provision (whether reported or not);

- UPP; and
- unexpired risks provision.

The unexpired risks provision was discussed under section 2.4.5. The terms ‘provisions’ and ‘reserves’ used in APN 401 have different meanings from those used in IFRS. Provisions and reserves in APN 401 and Circular 2/2007 refer to insurance liabilities. Collectively, insurance liabilities are called technical provisions in APN 401 (ASSA, 2013: Glossary).

2.5.1 Claims provisions

Claims provisions are an entity’s contractual obligations to assess and settle claims incurred by the entity under insurance contracts, whether or not these claims have been reported. These obligations are attributable to the past services provided by an entity to policyholders according to the terms and conditions of an insurance contract.

The claims provisions can be divided into two categories; namely the reported claims and the IBNR claims provisions. The provision for reported but not paid claims can also be categorised into two components. The one component represents the liability for assessed claims that have not been paid. This component of the claims liability represents an accurate measure of the entity’s obligations. The second component represents liabilities for reported claims that have not yet been fully assessed and priced (Aiuppa & Trieschmann, 1987).

Since the exact amounts of the ultimate loss payments are unknown at the reporting date, there is an element of measurement uncertainty regarding this component of incurred claims. APN 401 describes this component as a provision for the future development on known claims i.e. *Incurred But Not Enough Reported* claims (ASSA, 2013: para. 3.2.3). The other sub-components of claims provisions are provisions for reopened claims, provisions for profit commissions and accruals for claims handling expenses (*ibid.*).

Incurred but not reported claims provision

Entities are expected to have IBNR claims provisions because of the time delay between the dates of loss and the date of reporting of the claim to the insurers.

Because these claims are already incurred at the reporting date, even though they are not yet known to the insurer, it is a financial reporting requirement in terms of IFRS 4 to recognise an IBNR claims liability (IASB, 2004). However IFRS 4 does not provide guidance on how to estimate this liability.

The liability for IBNR claims should be calculated according to the formula prescribed in paragraph 4.3 of the Board Notice (South Africa, 2011). Insurers can apply to the Registrar of short-term insurers for permission to use alternative methods to calculate the value of the IBNR claims liability, if the application of such alternative methods leads to fairer results. The prescribed method is based on various IBNR factors, applied to the current and historic earned premiums. These premiums should be reduced by approved reinsurance premiums for the whole of the accounting period. Table 2.2 shows the prescribed factors for determining the IBNR claims provision per development year for each class of business according to the Board Notice.

Table 2.2: The IBNR Factors per development year

Development Year		0	1	2	3	4	5
	Business Class ^{k}		**Factors per development period ($f_{k,i}$)**				
1	Accident and Health	5.67%	1.12%	0.26%	0.10%	0.07%	0.06%
2	Engineering	6.62%	2.90%	1.92%	1.67%	1.60%	1.58%
3	Guarantee	16.32%	5.00%	1.78%	0.86%	0.60%	0.53%
4	Liability	12.49%	4.47%	1.65%	0.66%	0.31%	0.19%
5	Miscellaneous	7.18%	1.17%	0.25%	0.11%	0.09%	0.08%
6	Motor	3.43%	0.47%	0.09%	0.04%	0.03%	0.03%
7	Property	5.98%	0.88%	0.15%	0.04%	0.03%	0.02%
8	Transportation	7.20%	1.31%	0.30%	0.12%	0.09%	0.09%

Source: Board Notice 169 of 2011 (South Africa, 2011: 10)

Previously, Board Notice 27 of 2010 prescribed that the IBNR claims liability be calculated at 7% of the net (of reinsurance) premiums payable to the insurer under policies incepted in the 12 months preceding the valuation date (South Africa, 2010). Table 2.2 represents the requirements of Board Notice 169 of 2011, which replaced Board Notice 27 of 2010 (i.e. the 7% requirement). These IBNR factors are multiplied by the net earned premiums per development year to arrive at the IBNR claims liability.

Based on Table 2.2, assume an entity earned the premiums shown in Table 2.3 over the past five years from its motor insurance business. The calculation shows how to determine the IBNR claims liability at the end of 2017 using the IBNR factors in Table 2.2 and the premium information provided in Table 2.3.

Table 2.3: Example of earned premiums from motor business.

	2017	2016	2015	2014	2013	2012
Net Earned Premium (R'm)	150	110	100	90	80	70

Source: Adopted from ST2015 Guidance Manual (FSCA, 2015: 31)

Table 2.4: Example of IBNR Calculation for motor business

Motor Business	**Factors per development period ($f_{k,i}$)**					
	0	**1**	**2**	**3**	**4**	**5**
Year	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**
Factor per development period (from Table 2.2)	3.43%	0.47%	0.09%	0.04%	0.03%	0.03%
Net Earned Premium (R'm) (from Table 2.3)	150	110	100	90	80	70
Result (NEP x $f_{k,i}$)	5.145	0.517	0.09	0.036	0.024	0.021

Source: Adopted from ST2015 Guidance Manual (FSCA, 2015: 31).

The calculation in Table 2.4 results in an IBNR claims liability of R5.8 million at the end of 2017 for motor business, determined by summing up the values in the last row.

2.5.2 Premium provisions

Premium provisions are insurance liabilities relating to the unexpired period for insurance premiums already received by the entity. According to APN 401, premium provisions are set up to provide for future claim payments arising from future events covered under existing insurance contracts for which premiums have already been received (ASSA, 2013: para. 3.2.4). Although APN 401 is based on the Board Notice, there is a notable inconsistency between the Board Notice and APN 401 regarding the amount of premiums that should be utilised to determine the UPP balance. APN 401 requires actuaries to use the premiums already received to determine the amount of UPP (ASSA, 2013: para. 3.2.4), however the Board Notice requires an insurer to use the premiums for the entire coverage period of the insurance policy to determine UPP, irrespective of whether the premiums have been received by the insurer at the reporting date (South Africa, 2011: sec. 4).

APN 401 states that the premium provisions should provide for amounts in respect of the anticipated expenses relating to claims, policy administration and claims handling costs (ASSA, 2013: para. 3.2.4). Additionally, premium provisions should also include allowances for cash back bonuses. These bonuses are benefits provided for in contracts that entitle policyholders to predetermined benefits on the expiry of specified periods and under specified circumstances (ASSA, 2013: para. 3.2.5).

Cash back bonuses

The Board Notice defines a cash back bonus as a benefit provided for in an insurance contract that entitles a policyholder to a predetermined benefit on the expiry of a specified period and under circumstances specified in the contract (South Africa, 2011). According to the VAT 421 – *Guide for Short-Term Insurance*, a cash back bonus arises when cash is paid to the policyholder as a result of that person not making any claims on the policy over a specified period of time (SARS, 2013). This is similar to a loyalty programme in which a service provider provides a cash-back incentive to a customer for performing the desired action (Alderfer & Roen, 2010).

The Board Notice requires the cash-back reserve to be treated as a component of UPP and presented separately on the regulatory return (FSCA, 2015). South African short-term insurers who adopted this regulatory requirement in financial reporting do not have to unbundle cash back components as the Board Notice already requires the cash back bonuses to be recognised as a component of UPP.

Similarly, APN 401 requires cash back bonuses to be included in the UPP balance, taking into account factors such as benefits payable in terms of the contract, accumulated points at the valuation date, anticipated claims between the valuation date and the bonus payment date, expected premium increases and anticipated lapses (ASSA, 2013).

2.5.3 Application of APN 401 to financial reporting

The valuation approach of APN 401 requires the inclusion of all claims and administration costs incurred up to the reporting date, to the extent unpaid, in the value of the claims provision (ASSA, 2013: para. 3.2.3). Similarly, UPP should be determined based on premiums received by the entity up to the reporting date. APN 401's valuation approach is similar to the accrual basis of accounting adopted by the IASB. According to the Framework, the accrual basis of accounting is described as follows:

> "Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period" (IASB, 2018: para. 1.17).

On the basis of the approach adopted by ASSA and the IASB's accrual accounting principles, it can be concluded that the determination of UPP and claims estimation methodology for regulatory reporting are consistent with the principles of accrual accounting for financial reporting purposes.

2.6 The FSCA's regulatory reporting requirements

The preceding discussion about the Board Notice and APN 401 formed part of the FSCA's regulatory requirements. The previous section focused on the measurement of insurance liabilities, whereas this section focuses on the presentation of regulatory financial statements adopted in financial reporting by short-term insurers.

The FSCA supervises and enforces the compliance and financial soundness of insurers, and their governance and business conduct in terms of the STI Act. They are also responsible for the development of the short-term insurance regulatory proposals (FSCA, 2019). Following the 2008 global financial crisis, the National Treasury and the FSCA initiated financial regulatory reforms, which resulted in the evolution of the then Financial Condition Reporting (hereafter FCR) to the Solvency

Assessment and Management (hereafter SAM) regime (van Vuuren, Reyers & van Schalkwyk, 2017). SAM, which is based on the European Solvency II, seeks to establish a risk-based prudential regulation regime for South African insurers.

According to the FSCA (2012), SAM has three established committees, which play oversight roles relating to short-term insurers' quantitative aspects (SAM Pillar I), governance and risk aspects (SAM Pillar II) and reporting requirements (SAM Pillar III). Short-term insurers are required to submit quarterly and annual reports on prescribed forms called 'short-term insurance returns', or 'returns'.

The structure and content of the regulatory returns are an integral part of the existing accounting practice as they supplement the gaps in IFRS 4. For example, the regulatory returns provides a useful presentation structure of a short-term insurer's income statement since IFRS 4 does not cover presentation issues in detail. Similarly, the Board Notice prescribes the IBNR claims provision determination method for short-term insurance policies, which is also useful in the determination of insurance liabilities for financial reporting. The requirements of the board notice are discussed in section 2.5.

2.6.1 Presentation

IFRS 4 provides insufficient accounting guidance for the presentation of insurance contracts in the reporting entity's financial statements. The Circular exclusively provides recognition and measurement guidance. The FSCA's STI Act returns are the only source of presentation guidance for South African short-term insurers.

Statement of Comprehensive income

The FSCA's statement of comprehensive income shown in Table 2.5 provides some useful presentation guidance for short-term insurers in South Africa. However, the FSCA presentation structure includes gross amounts in the statement of comprehensive income, and offsets reinsurance premiums against gross written premiums, contrary to the implementation guidance of IFRS 4 (IASB, 2004: para. IG24a). The net insurance premium revenue is the result of adjusting gross written premiums for reinsurance premiums and the UPP movement during the reporting period. IFRS 4 requires reinsurance premiums to be presented separately as expenses, not as an adjustment to gross premiums to obtain insurance revenue (refer to items 2 and 7 in Table 2.5). Additionally, if the insurer uses the services of insurance brokers, commission (insurance acquisition costs) should also be presented separately. Refer to Table 2.5 line 15 (FSCA, 2016).

Table 2.5 – FSCA Statement of comprehensive income (extract)

1	**Gross written premium**	
2	Less: reinsurance written premium	
3	**Net premium**	
4	Less: change in unearned premium	
5	Gross amount	
6	Reinsurers' share	
7	**Net insurance premium revenue**	
8	Investment income	
9	Income from reinsurance contracts ceded	
10	Net gain/(loss) on financial assets and liabilities at fair value	
11	**Net income**	
12	Insurance claims and loss adjustment expenses	
13	Insurance claims and loss adjustment expenses recovered	
14	**Net insurance benefits and claims**	
15	Expenses for the acquisition of insurance contracts	

Source: FSCA (2016): STI Annual Return

Statement of financial position

In South Africa, the FSCA's structure of the statement of financial position provides some useful presentation guidance for short term-insurers. In this guidance, the majority of insurance assets and liabilities are presented either under current assets and liabilities or technical assets and liabilities. Table 2.6 is an extract of the current assets section of the FSCA statement of financial position (Statement C2) in the short-term insurance annual return.

Table 2.6: Short-term insurers current assets section

Current Assets	
Agents' and reinsurers' balances	
Deposits with reinsurers	
Other receivables	

Source: FSCA (2016): STI Annual Return

From Table 2.6, it can be seen that in order to comply with IFRS 4 and IAS 1, agents' and reinsurers' balances, other receivables (including premium debtors), and deposits with reinsurers should be presented separately (IASB, 2004: para. IG22g).

Neither IFRS 4 nor Circular 2/2007 specifically requires the separate presentation of DAC, however DAC is presented separately in the FSCA's technical assets section of Statement C2 (see table 2.7 below). Technical assets are assets that arise directly from recognised insurance contracts. Table 2.7 is an extract from Statement C2 of the FSCA's annual short-term insurance return.

Table 2.7: Short-term insurers' technical (insurance) assets section

Technical assets	
Reinsurers' share of provision for unearned premiums	
Reinsurers' share of outstanding claims	
Deferred acquisition costs	

Source: FSCA (2016): STI Annual Return

Table 2.8 details the short-term insurer's liabilities section in Statement C2 of the FSCA's annual return.

Table 2.8: Short-term insurers' technical liabilities section

Technical liabilities	
Gross provision for unearned premiums	
Due to cell owner	
Gross outstanding claims	
Deferred reinsurance commission revenue	
Current Liabilities	
Agents' and reinsurers' balances	
Deposits by reinsurers	

Source: FSCA (2016): STI Annual Statutory Return

Statement E9 of the annual short-term insurance return lists the short-term insurer's assets and liabilities and compares them to the financial statements (FSCA, 2016). The assets in this statement are not categorised into non-current, current and technical assets. This is the same structure used in the short-term annual insurance return (FSCA, 2016). However, IAS 1 also permits a presentation structure based on liquidity (IASB, 2007: para. 60), which short-term insurers can also adopt. IFRS 4 does not prescribe the presentation format of an insurer's statement of financial position.

2.7 Conclusion

This chapter describes the financial and regulatory reporting aspects of short-term insurance contracts and how they form the current accounting model in South Africa. The existing accounting model for short-term insurance contracts in South Africa is based on IFRS 4, Circular 2/2007, and the FSCA regulatory guidance, which includes APN 401. While IFRS 4 contains limited accounting guidance relating to the identification and disclosure requirements for insurance contracts, it does not provide sufficient recognition and measurement guidance.

The recognition and measurement of short-term insurance contracts is covered by Circular 2/2007. The Circular provides guidance that follows an income statement view of insurance accounting, which gives prominence to the recognition and measurement of income statement items and the deferral of residuals to the statement of financial position. Both Circular 2/2007 and IFRS 4 do not address presentation of insurance contracts, except for the off-setting guidance in IFRS 4.

The revenue recognition model followed under the existing accounting model results in recognition of earned premiums as revenue. The FSCA's presentation guidance (refer to Table 2.5) shows the net earned premiums after deduction of reinsurance premiums. IFRS 4 does not permit offsetting of reinsurance premiums against written premiums to determine an insurer's revenue. It does not require the determination of net written premiums, which is a regulatory reporting requirement. Hence, there are differences on how to determine revenue between IFRS 4 and the FSCA's method.

There is limited presentation guidance in IFRS 4, consequently the implementation guidance refers insurers to the IAS 1 requirements and to use judgement to determine the minimum information requirements for presentation in the statements of comprehensive income and financial position. The FSCA's statement of comprehensive income and statement of financial position provide useful guidance for the presentation of an insurer's financial statements. IFRS 4 requires disclosures which provide information about amounts recognised in the financial statements and the nature and extent of risks arising from recognised insurance contracts.

In May 2017, the IASB issued IFRS 17, a comprehensive IFRS on insurance contracts that supersedes the current accounting model. The next chapter describes the accounting treatment of short-term insurance contracts in terms of IFRS 17.

Chapter 3. IFRS 17: Insurance contracts

3.1 Introduction

This chapter describes the financial reporting principles established in IFRS 17: *Insurance Contracts*. The existing accounting model for short-term insurance contracts was discussed in the previous chapter. The main aim of this chapter is to describe the accounting treatment of short-term insurance contracts under IFRS 17.

The IASB issued IFRS 17 in May 2017, after thirteen years of working on Phase II of the insurance project, with the objective of addressing all issues not addressed in Phase I. IFRS 17 supersedes IFRS 4 and is effective for annual periods beginning on or after 1 January 2021 (IASB, 2017). The objective of IFRS 17 is to establish financial reporting principles for the identification, recognition, measurement, presentation and disclosure of insurance contracts (*ibid.*).

IFRS 17 establishes measurement principles for insurance contracts which are intended to be more aligned with other financial reporting standards. For example, measurement of insurance revenue under IFRS 17 is expected to be consistent with the measurement principles established in IFRS 15 *Revenue from Contracts with Customers*, subject to some exceptions. Similarly, the measurement requirements for insurance liabilities are consistent with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IASB, 2017). The derecognition principles of insurance liabilities under IFRS 17 are also consistent with the derecognition principles for financial liabilities in terms of IFRS 9.

IFRS 17's general measurement model is based on the concept of fulfilment cash flows. According to the Framework, fulfilment value is the present value of the economic resources that an entity expects to be obliged to transfer as it fulfils a liability (IASB, 2018: para. 6.17). IFRS 17 defines fulfilment cash flows as explicit, unbiased and probability-weighted estimates of the present value of the future net cash flows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk (IASB, 2017: Appendix A).

IFRS 17 includes a simplified version of the GMM, called the premium allocation approach. The PAA is intended for insurance contracts in situations where the measurement results achieved using the PAA approximate the results produced by measuring contracts using the GMM, or for short-duration contracts where the coverage periods do not exceed one year (IASB, 2017). Most short-term insurance contracts are likely to meet the PAA measurement criteria due to their short-term nature, which makes them simpler to measure than long-term contracts.

Figure 3.1 outlines the structure of Chapter 3. In this chapter, the recognition, measurement, modification and derecognition, and disclosure requirements for short-term insurance contracts in terms of IFRS 17 will be described.

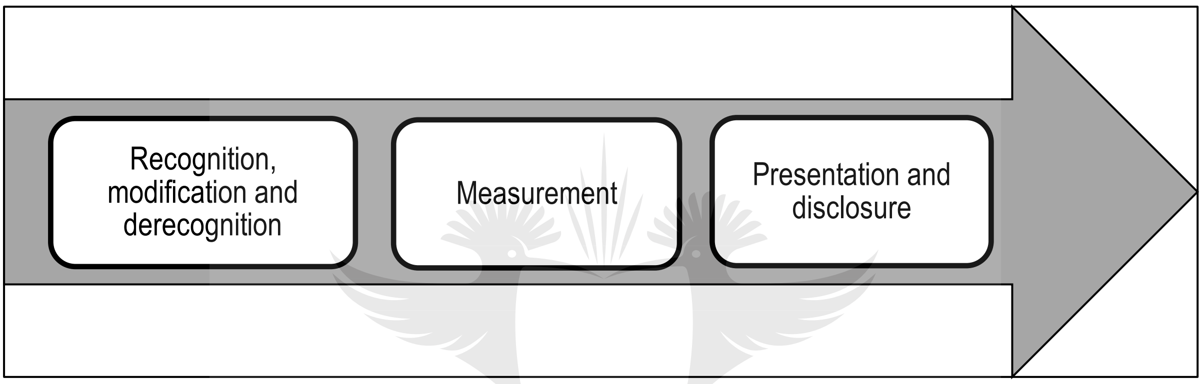

Figure 3.1: Structure of Chapter 3

Source: Own construction

3.2 Recognition, modification and derecognition

This section covers the initial recognition, modification of insurance contracts and derecognition requirements in terms if IFRS 17.

3.2.1. Initial recognition

In terms of IFRS 17, an insurer should recognise an insurance contract, or a group of insurance contracts, from the earliest of the following:

- the beginning of the coverage period, or
- when payments for the insurance coverage fall due, or
- when the contract is onerous (IASB, 2017: para. 25).

The recognition principles established in IFRS 17 are similar to those of IFRS 15, which are based on performance. An insurance contract should be recognised when the first party has an obligation to perform, rather than at the time the insurer accepts the insurance risk (IASB, 2017: para. BC140). If an entity recognises an insurance contract when it accepts the insurance risk, it may result in the recognition of the contract before commencement of the insurance cover, which may result in operational complications and costly system requirements (IASB, 2017: para. BC141). If the insurance contract does not specify the start date, the contract should be recognised when the entity receives the first insurance premium from the policyholder (IASB, 2017: para. 25).

IFRS 17 requires an entity to recognise an asset for insurance acquisition cash flows that it incurs before the coverage period begins (i.e. before the initial recognition of the insurance contract), unless it adopts the option of expensing the acquisition costs when they are incurred. This asset should be derecognised when the insurance contract is recognised and included in the measurement of the contract (IASB, 2017: para. 27).

The reason for the derecognition of this asset once the coverage period begins is that the measurement model of IFRS 17 does not permit the separate capitalisation of insurance acquisition cash flows because such an asset either does not exist, if the entity expects to recover the insurance acquisition cash flows from premiums already received, or it relates to future cash flows that are included in the measurement of the contract. To achieve a faithful representation, the liability for the remaining coverage should not include the portion of premiums allocated to the cost of originating the contracts (IASB, 2017: para. BC176).

Hence, if insurance acquisition cash flows are incurred before the coverage period begins, and before any premiums are received, IFRS 17 requires the recognition of an asset for these costs (IASB, 2017: para. 27). The asset recognition under these circumstances is appropriate on the basis that premiums pertaining to those insurance acquisition cash flows will be received in the future, representing future economic benefits at the time of recognition (Liu & Liao, 2016).

IFRS 17 requires the recognition of insurance contracts as soon as they become onerous, even before the coverage period begins (IASB, 2017: para. BC141). The recognition of onerous contracts as soon as they are identified is a principle that was established by the International Accounting Standards Committee (hereafter IASC) in IAS 37. According to IAS 37, an entity is required to recognise onerous contracts as provisions (IASC, 1998: para. 66). Paragraphs 47–52 of IFRS 17 address the accounting treatment of insurance contracts that are onerous and require the recognition of any losses arising from these onerous contracts in profit or loss (IASB, 2017). One of the objectives of IFRS 17 is to achieve consistency with IAS 37 in relation to the recognition and measurement of insurance liabilities (IASB, 2017: para. IN7b).

3.2.2. Modification and derecognition

Modification and derecognition of insurance contracts are closely related. Modification of contracts can lead to the derecognition of an existing contract and the recognition of a new contract with the modified terms. Derecognition results in the removal of the contract from the financial statements.

Modification

Modification of an insurance contract occurs when the original terms of the contract are changed such that the modified terms should be accounted for differently from the original terms (IASB, 2017: para. BC317). These modified terms include situations where, for example;

- the introduction of new terms would have resulted in the contract being out of the scope of the standard at contract inception,
- the unbundling would have resulted in an insurance contract with different terms due to the modification,
- the modification results in a contract with a significantly different contract boundary, or
- the modified contract would have been allocated to a different group of insurance contracts (IASB, 2017: para. 72a).

Modification also occurs when the original contract was an insurance contract with direct participation features according to IFRS 17, but the modified contract no longer meets the requirements to account for the contract according to the original terms, or vice versa. Additionally, modification occurs when the entity applied the PAA to the original contract, but the changes result in the contract no longer meeting the eligibility criteria for applying the PAA. An exercise of options specified in the original terms of the contract is not a contract modification (IASB, 2017: para. 72).

When an insurance contract is modified, IFRS 17 requires the derecognition of the original contract and the recognition of the modified contract as a new contract, applying IFRS 17 or other applicable Standards *(ibid.)*

Derecognition

In terms of IFRS 17, an insurance contract should be derecognised when the obligation specified in the contract is discharged or cancelled or expires (IASB, 2017: para. 74). Additionally, an insurance contract meets the derecognition requirements of IFRS 17 if it is substantially modified. IFRS 17 has specific derecognition requirements for contracts rather than for individual assets or liabilities. Under IFRS 17, there is one model for derecognition of contracts, regardless of whether they are liabilities or assets. The test for derecognition is whether the entity is no longer at risk of transferring economic resources to other parties under the existing contractual terms (IASB, 2017: para. 75).

The derecognition requirements of IFRS 17 are similar to those of IFRS 9. IFRS 9 requires the derecognition of a financial liability when it is extinguished, i.e. when the obligation is discharged, cancelled or expires (IASB, 2014: para. 3.3.1). Other IFRS 9 derecognition requirements include significant modification of the original contract that results in the derecognition of the old contract and the recognition of another contract with substantially modified terms (IASB, 2014: para. 3.3.2 and B3.3.3).

3.3 Measurement

Before analysing the measurement requirements of IFRS 17, it is necessary to consider the process that the IASB, through its consultation process, went through from 1999 until the issuing of IFRS 17 in 2017. As illustrated in Figure 3.2, until 2007 there were strong views in favour of a fair value measurement model for insurance contracts. These views changed in the 2010 Exposure Draft following the IASB's further deliberations and the consultation process. Figure 3.2 illustrates these views on a time line until the issue of IFRS 17 in 2017. The last column was added by the author to the original illustration compiled by Nguyen and Molinari in 2013.

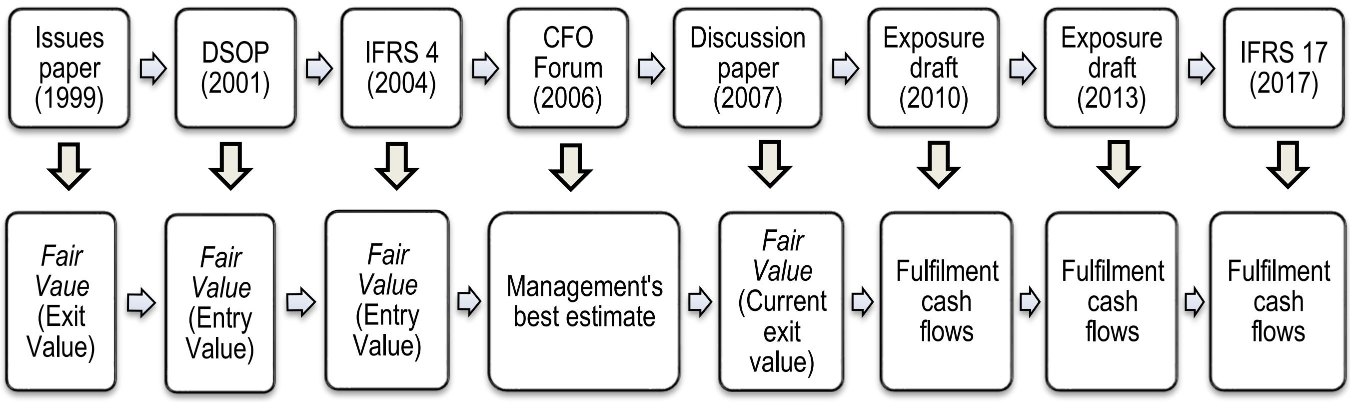

Figure 3.2 – Development of proposed measurement models

Source: Nguyen and Molinari, (2013: 376-398 (adapted))

IFRS 13: *Fair Value Measurement* defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (IASB, 2011: para. 9). According to the conclusions reached in IFRS 17, the reasons for moving away from the fair value model for insurance contracts are that:

- insurance contracts are serviced through the provision of insurance services rather than sold or transferred in active markets;
- the definition of fair value emphasises that fair value is a market-based measurement, not an entity-specific measurement;
- insurance contracts are generally serviced by fulfilling the cash flow requirements specific to each contract, and these cash flow commitments reflect the perspectives of the entity (hence entity-specific); and
- developing a fair value measurement model for contracts that are not actively traded would result in basing the model on hypothetical transactions that rarely occur (IASB, 2017: para. BC17).

Except for portfolio transfers and business combinations, which are not regular transactions in the business models of most insurers, transactions involving buying and selling insurance contracts between insurers are rare. Insurers generally fulfil insurance contracts through collecting premiums and paying claims, rather than by acquiring and selling contracts to third parties (IASB, 2017). Hence, the IASB concluded that the most appropriate measurement model for insurance contracts should be one based on fulfilment cash flows. The relevant fulfilment cash flows that should be included in the measurement of insurance contracts are those cash flows within the boundaries of the insurance contract.

3.3.1 Cash flows within the boundary of the insurance contract

IFRS 17 defines the coverage period as the period in which the insurer provides insurance cover for insured events. The period includes the insurance cover that pertains to all premiums within the insurance contract boundary (IASB, 2017: Appendix A). The contract boundary distinguishes whether future premiums, and the resulting benefits and claims, arise from existing insurance contracts or future insurance contracts (IASB, 2017: para. BC159). The measurement model of IFRS 17 requires an entity to incorporate all cash flows in the contract boundary when measuring a group of insurance contracts. These cash flows should not include other cash flows outside the boundary of the contract (IASB, 2017: para. 34).

For cash flows to be within the contract boundary, IFRS 17 requires that they should arise from substantive rights and obligations arising from the contract during the reporting period. These rights should be capable of compelling the policyholder to pay the insurance premiums, and the obligations should compel the entity to provide the insurance services to the policyholder (IASB, 2017: para. 34). Substantive rights and obligations are matters of the contract and applicable laws, and IFRS 17 requires an entity to consider these legal provisions when applying the standard (IASB, 2017: para. 2).

Sometimes the contract boundary is unclear from the wording of the insurance contract. This occurs when the contract has options that may significantly change the coverage period. Such options include renewal, conversion, surrender or cancellation options. In these situations, IFRS 17 requires an insurer to apply judgement in determining the contract boundaries.

Figure 3.3 illustrates cash flows within the contract boundary.

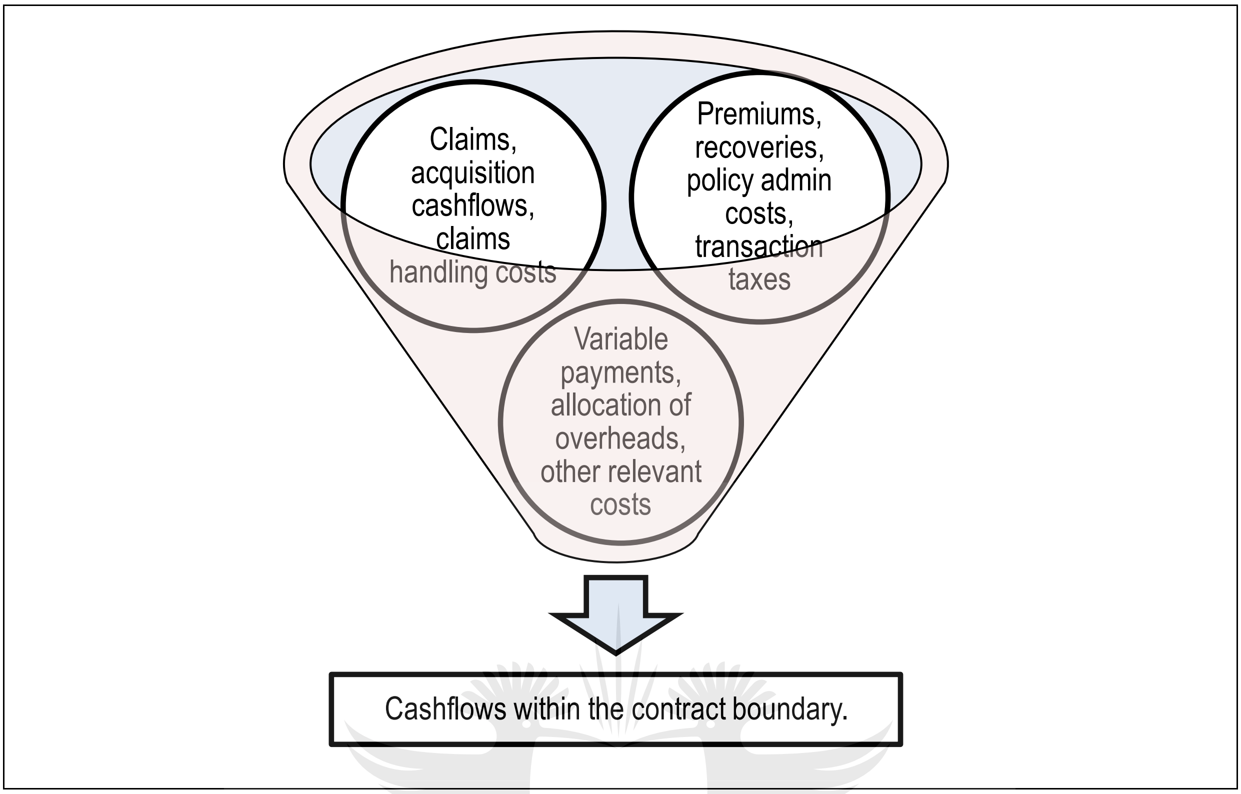

Figure 3.3 – Cash flows within the contract boundary

Source: Own construction

IFRS 17 requires that the measurement of a group of insurance contracts should reflect, on the balance of probabilities, the entity's current estimates based on the entity's expectations of the policyholder behaviour, i.e. how the policyholders are likely to exercise their available options. In terms of IFRS 17, when measuring a group of insurance contracts, it is inappropriate for an issuer to assume that all contracts in the group will lapse if it is probable that some policyholders will continue with their policies under the current contractual terms, or that all contracts in the group will persist if it is probable that some contracts will lapse (IASB, 2017: para. B62).

According to IFRS 17, the contract boundary ends when the entity has the practical ability to reassess the insurance risk and reprice the insurance contract or the portfolio of relevant insurance contracts to reflect the repricing for the revised risks, even if the individual policies in the portfolio are not reassessed. This reassessment takes the form of performing the underwriting process

(IASB, 2017: para. 34; B64 & BC161–BC164). Any cash flows that arise after this point should not be included in the measurement of the insurance contract before the reassessment.

IFRS 17 does not permit recognition of assets or liabilities relating to future cash flows (premiums, claims and costs) outside the contract boundary as these cash flows relate to future insurance contracts (IASB, 2017: para. 35).

3.3.2 The general measurement model

The GMM is comprehensive, but can be simplified if the insurance contracts meet certain criteria described below. The focus of this research is on the PAA, which is the simplified version of the GMM. Before discussing the PAA, it is necessary to provide an outline of the GMM.

On initial recognition of a group of insurance contracts, IFRS 17 requires entities to measure these contracts at the sum of the fulfilment cash flows and to incorporate the contractual service margin (IASB, 2017: para. 32). Fulfilment cash flows are the net expected cash flows from discharging an entity's obligations under an insurance contract, incorporating a non-financial risk adjustment. They include estimates of future cash flows falling within the boundaries of an insurance contract.

IFRS 17 identifies the specific fulfilment cash flows for the purposes of measuring insurance contracts, which comprise premiums, claims, insurance acquisition cash flows and other cash flows specific to the insurance activities of the entity (IASB, 2017: para. B65). These cash flows should be adjusted by the contractual service margin. The contractual service margin is the unearned profit of the insurance contract that should be recognised as the entity provides the insurance coverage (IASB, 2017: para. 38).

Without incorporating the contractual service margin in the measurement model, a situation would arise where day one gains would be recognised on the initial recognition of an insurance contract together with a corresponding insurance asset, before the entity provides any insurance services. The contractual service margin eliminates this profit and the potential asset so that, on initial recognition, the potential asset and the profit are reduced to zero. However, if the contract is onerous, IFRS 17 requires the immediate recognition of an insurance liability

(IASB, 2017: para. 25).

In terms of the recognition and measurement requirements of IFRS 17, the rights and obligations arising from an insurance contract are inseparable. Consequently, a single insurance contract cannot result in the recognition of various assets and liabilities. Hence, all the cash flows arising from an insurance contract are measured as a single item. In terms of the Framework, if the rights and obligations are interdependent and cannot be separated, they constitute a single inseparable asset or liability and hence form a single unit of account (IASB, 2018: para. 4.53).

IFRS 17 requires fulfilment cash flows to reflect the perspective of the issuer, take into account all available information without incorporating any bias, be current and incorporate a non-financial risk adjustment. These cash flows should be discounted and financial risk should not be incorporated in the determination of the fulfilment cash flows (IASB, 2017: para. 36). The fulfilment cash flows should also be adjusted for the effect of non-financial risk (IASB, 2017: para. 36). Non-financial risk is the uncertainty relating to the amount and timing of fulfilment cash flows.

Examples of non-financial risk are insurance risk, lapse risk and persistency risk. Lapse risk is the risk that a policyholder cancels their policy earlier than anticipated, and persistency risk is the risk that a policyholder cancels their policy later than anticipated. The size of this adjustment is at the discretion of the reporting entity. The downside of this discretion is that it could lead to financial reporting abuses such as earnings manipulation (Nguyen & Molinari, 2013).

Subsequent to the initial recognition of insurance contracts, IFRS 17 requires insurance liabilities to be measured as the sum of two components, namely the liability for remaining coverage and the liability for incurred claims (IASB, 2017: para. 40). The liability for the remaining coverage comprises the fulfilment cash flows allocated to future services at the measurement date, and the contractual service margin.

The liability for incurred claims are the fulfilment cash flows allocated to the past services at the measurement date. Both the fulfilment cash flows allocated to the future and past services are determined in the same manner, i.e. the cash flows should be within the boundary of each insurance contract, and should be adjusted for the effects of the time value of money as well as for non-financial risk (IASB, 2017: para. 40). In terms of IFRS 17, the GMM should be applied to all insurance contracts. However, entities can choose to apply the PAA instead of the GMM depending on the eligibility of the insurance contracts concerned.

Figure 3.4 illustrates the components of the insurance liabilities.

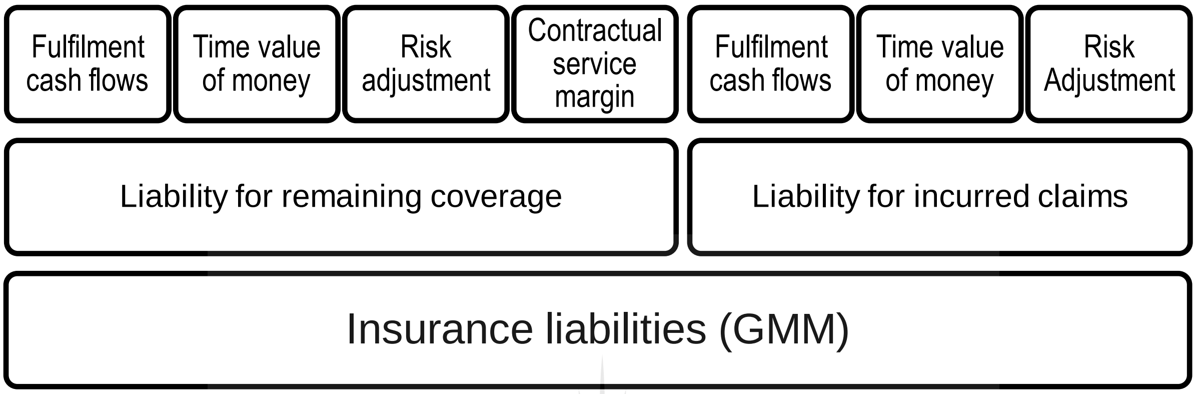

Figure 3.4: Insurance liabilities under the GMM

Source: Own construction

Financial performance under the GMM

IFRS 17 requires the recognition of revenue and expenses based on the changes in the balance of the liability for the remaining coverage. Revenue should be recognised for the decrease in the liability for the remaining coverage as a result of the insurance services that were provided during the reporting period (IASB, 2017: para 41a). Paragraph 83 of IFRS 17 requires that

> "Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services" (IASB, 2017).

In terms of IFRS 17, an entity is required to recognise the change in the liability for incurred claims in the statement of financial performance as insurance service expenses. Insurance service expenses include the increase in the liability due to claims and claims handling expenses incurred during the reporting period, including experience adjustments on previous estimates. The change in the liability also includes the insurance finance income or expenses, which should be recognised separately in the statement of financial performance (IASB, 2017: para. 42).

3.3.3 The Premium Allocation Approach

IFRS 17 contains a simplified measurement approach for certain qualifying insurance contracts called the premium allocation approach (IASB, 2017: para. 53). This approach is optional if the entity does not wish to apply the GMM, provided the insurance contracts meet the IFRS 17 criteria for applying the PAA. An entity can opt to apply the PAA to the measurement of insurance contracts provided the measurement simplification of the liability for the remaining coverage provides a reasonable approximation of the GMM liability described in paragraphs 32 to 52 of IFRS 17 (IASB, 2017: para. 53).

Alternatively, the PAA can be applied to measure insurance contracts with coverage periods not exceeding one year (IASB, 2017: para. 53). According to IFRS 17, the coverage period is the period during which the insurer provides the insurance services for the insured risks. The following simplifications are available under the PAA:

- The liability for the remaining coverage is initially measured at the amount of the premiums received, adjusted for insurance acquisition cash flows that are not expensed;
- An entity is not required to discount the liability for the remaining coverage for groups of contracts that do not have a significant financing component;
- An entity does not need to perform an onerous assessment test unless facts and circumstances indicate otherwise;
- An entity is permitted to expense all insurance acquisition cash flows for contracts with coverage periods of one year or less;
- The liability for incurred claims need not be discounted if the claims are expected to be paid within one year;
- There is no requirement to determine the contractual service margin; and
- The discount rate used for the liability for incurred claims with significant financing component is the discount rate determined on the initial recognition of this liability (IASB, 2017).

Liability for the remaining coverage under the PAA

On initial recognition, entities that apply the PAA should measure the liability for the remaining coverage at the amount of premiums received, adjusted for any insurance acquisition cash flows that are not expensed (IASB, 2017: para. 55a). At each reporting date after the initial recognition of the group of insurance contracts, the liability for remaining coverage should be determined by adjusting the opening balance of the liability by the net movements in the UPP balance during the period, net of acquisition costs and any amortisation of pre-coverage cash flows.

Other adjustments to the liability for the remaining coverage relate to financing and investment components (IASB, 2017: para. 55b). If the insurance contracts have a significant financing component, the liability for the remaining coverage should be discounted. These adjustments are not required if, at initial recognition, the expected time between the provision of insurance services and the premium due date is less than one year (IASB, 2017: para 56). Figure 3.5 illustrates the components of the liability for the remaining coverage with a significant financing component under the PAA.

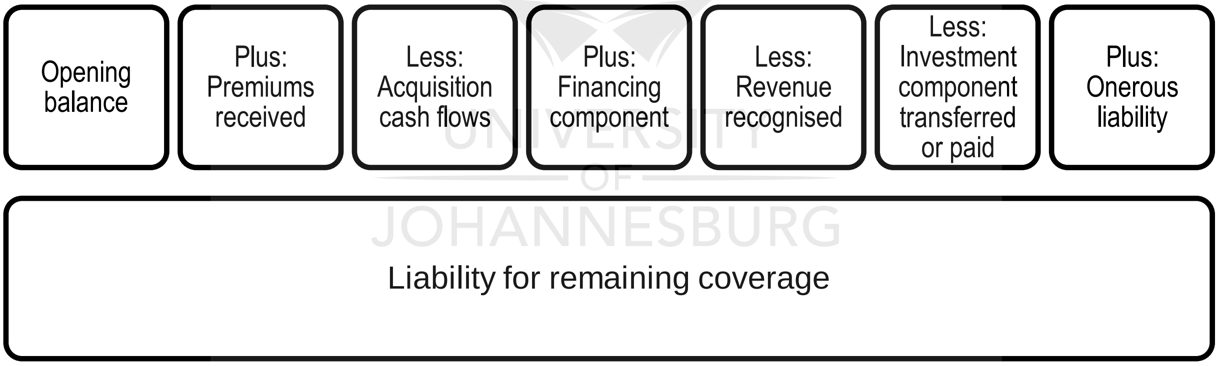

Figure 3.5: Liability for the remaining coverage under the PAA

Source: Own Construction

IFRS 17 requires the liability for the remaining coverage to be recognised over the coverage period on the basis of the passage of time, or on the basis of the expected timing of incurred claims, whichever is more appropriate (IASB, 2017: para. BC290).

When applying the PAA, if circumstances change to the extent that the group of insurance contracts becomes onerous, IFRS 17 requires the difference between the following amounts be determined (IASB, 2017: para. 57):

- The carrying amount of the liability for the remaining coverage determined according to the PAA, and
- The fulfilment cash flows determined in accordance with the GMM as illustrated in Figure 3.4.

If the liability determined in accordance with the PAA is lower, the onerous portion should increase the liability for remaining coverage, and the loss should be recognised in profit or loss (IASB, 2017: para. 58).

Liability for incurred claims

According to IFRS 17, the liability for incurred claims is the insurer's obligation to investigate, assess and compensate valid claims for insured events that have occurred, including insured events that have occurred, but have not yet been reported (IASB, 2017). This liability should also incorporate estimates of claims handling expenses. The liability for incurred claims under the PAA should be recognised once claims are incurred.

An entity is not required to adjust the claims liability for the effects of the time value of money if settlement of the claims is expected within one year from the date incurred (IASB, 2017: para. 59b). Other than the discounting exemption for short duration contracts, the liability for incurred claims determined under the GMM and the PAA are similar because under both models the entity should set aside amounts to settle claims and claims expenses (IASB, 2017: para. BC294). Figure 3.6 illustrates the components of the liability for incurred claims with a significant financing component under the PAA.

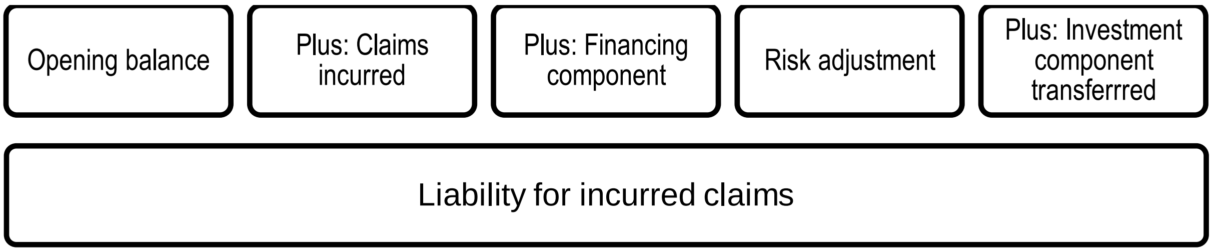

Figure 3.6: Liability for incurred claims under the PAA

Source: Own Construction

Figures 3.5 and 3.6 illustrated the components of insurance liabilities with significant financing components. In practice, short-term insurance contracts do not have significant financing components because premiums are generally paid in advance and claims are settled within short periods of time after the reporting date. Figure 3.7 illustrates the insurance liabilities under the PAA model, assuming both the liabilities for the remaining coverage and incurred claims do not have significant financing components.

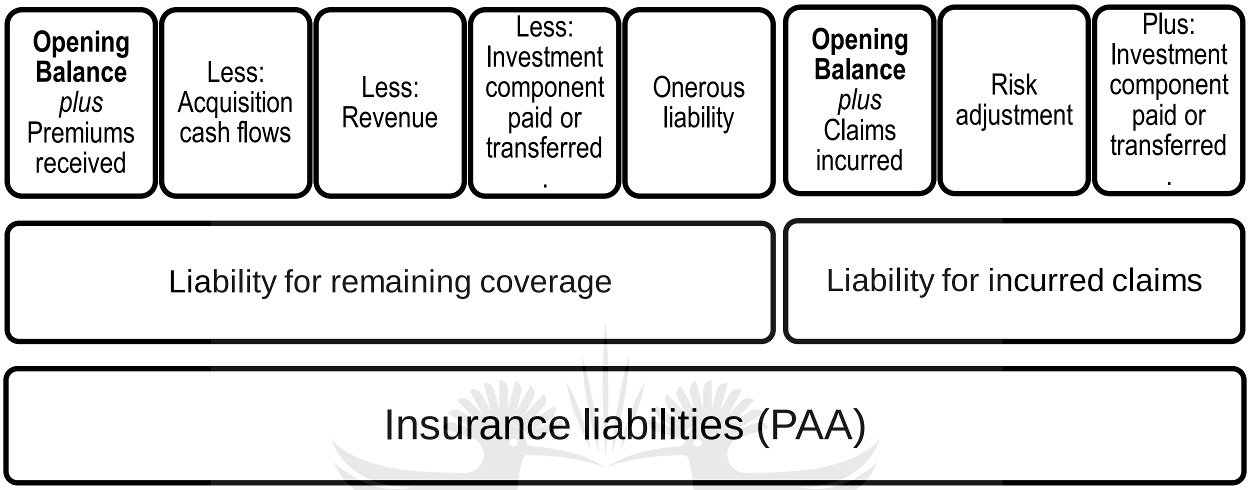

Figure 3.7: Insurance liabilities without significant financing (PAA)

Source: Own Construction

Risk adjustment for non-financial risk

When determining fulfilment cash flows, IFRS 17 requires an entity to adjust the present value of the future cash flows by the risk adjustment for non-financial risk. The purpose of the risk adjustment for non-financial risk is to reflect the compensation the entity would require for bearing the non-financial risk arising from the uncertainty in the amounts and timing of the cash flows arising from an insurance contract (IASB, 2017: para. 37 and B88). Non-financial risks are insurance and other risks, for example lapse and expense risks. The following example provided in IFRS 17 clarifies the need for this adjustment:

> "The risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that—because of non-financial risk—has a 50 per cent probability of being CU90 and a 50 per cent probability of being CU110, and fulfilling a liability that is fixed at CU100" (IASB, 2017: para. B87).

In terms of IFRS 17, the risk adjustment for non-financial risk should be determined based on a scale of probabilities. It should reflect the entity's current estimates of the expected behaviour of the policyholders and how they are likely to exercise their options (IASB, 2017: para. B62). In terms of IFRS 17, the risk adjustment for non-financial risk should have certain characteristics. The following characteristics result in a higher risk adjustment for non-financial risk (IASB, 2017: para. B91):

- Risks with low frequency and high severity;
- Contracts with a longer duration;
- Risks with a wider probability distribution;
- Little information about the current estimates; and
- The extent to which new risks increase the uncertainties about the amounts and timing of the fulfilment cash flows.

IFRS 17 requires an entity to use the confidence level to determine the risk adjustment for non-financial risk. If the entity chooses another technique, for example, the cost of capital, the entity should disclose the technique used and the confidence level corresponding to the results of that technique (IASB, 2017: para. 119).

PAA for reinsurance contracts held

IFRS 17 has accounting guidance for applying the PAA to reinsurance contracts held. The eligibility criteria for PAA for reinsurance held is similar to the eligibility criteria for insurance contracts an entity issues. An entity can apply the PAA to measure a group of reinsurance contracts held on initial recognition provided the resulting measurement does not differ materially from applying the GMM requirements, or the coverage period of each contract in the group of reinsurance contracts held is one year or less (IASB, 2017: para. 69). Thus, the PAA requirements for contracts an entity issues, discussed above, are adapted to reflect that reinsurance contracts held result in reinsurance assets and that the objective of taking reinsurance is to reduce expenses rather than to generate revenue.

3.4 Presentation in the statement of financial position

IFRS 17 requires the following assets and liabilities to be presented separately in the statement of financial position (IASB, 2017; para. 78):

- insurance contract assets,
- insurance contract liabilities,
- reinsurance contract assets, and
- reinsurance contract liabilities.

In terms of the Framework, the treatment of rights and obligations arising from the same contracts as a single unit of account differs from offsetting. Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the statement of financial position. Offsetting results in the classification of dissimilar items together (IASB, 2018: para. 7.10–7.11). This practice is generally inappropriate in terms of IFRS principles.

IFRS 17 treats each group of insurance contracts as a set of rights and obligations that are inseparable. Hence each contract or group of similar contracts leads to the recognition of a single asset or liability. IFRS 17 does not permit the offsetting of insurance assets against insurance liabilities. Similarly, an entity may not offset direct insurance contracts against reinsurance contracts in its statement of financial position. Reinsurance contracts should be presented separately, separating reinsurance assets from reinsurance liabilities (IASB, 2017: para. 78 & BC328).

3.5 Presentation in the statements of financial performance

Under the PAA, insurance revenue for the period is the amount of expected premium receipts systematically allocated to each reporting period. This amount excludes any investment component and should be adjusted to reflect the effect of time value of money and financial risk. The entity should allocate the premium cash flows to each period of coverage on the basis of the passage of time. However, if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, the allocation of the expected premium receipts over the coverage period should be based on the expected timing of incurred insurance service expenses (IASB, 2017: para. B126).

An entity is required to recognise separately the insurance service expenses, reinsurance held income and expenses, finance income and expenses and investment income (IASB, 2017). Insurance service expenses include incurred claims, acquisition costs, the risk adjustment, claims administration expenses and other directly attributable expenses, as well as an allocation of overheads.

3.5.1 Statement of profit or loss

An entity that issues insurance contracts should disaggregate the amounts recognised in the statement of profit or loss into an insurance service result and insurance finance income or expenses (IASB, 2017: para. 80). The insurance service result is the difference between insurance revenue and the insurance service expenses. According to IFRS 17, under the PAA an entity should recognise revenue based on the passage of time, or if earned unevenly, according to the expected timing of incurred insurance service expenses. The revenue should be recognised on the basis of allocating premiums received over the coverage period based on one of the two methods described above (IASB, 2017: para. 83 and B126).

Insurance service expenses include all expenses arising from recognised insurance contracts. Examples of these expenses are incurred claims, claims administration expenses and the amortisation of insurance acquisition cash flows. Additionally, the effect of past service changes to insurance liabilities and changes relating to future services attributable to onerous contracts should be recognised in profit or loss under insurance service expenses (IASB, 2017: para. 103b).

IFRS 17 requires the holder of a reinsurance contract to present the reinsurance contracts held income or expenses separately from income or expenses from the underlying insurance contracts issued by the entity (IASB, 2017: para. 82). In terms of IFRS 17, an insurer may present the reinsurance contracts held income or expenses as a single amount, or separately the amounts recovered from the reinsurer and the allocation of the premiums due to the reinsurer. If presented separately, the reinsurance held premiums paid and the amounts recovered from the reinsurer should give a net amount equal to that single amount (IASB, 2017: para. 86). The allocation of reinsurance premiums paid for reinsurance contracts should not be presented as a reduction of insurance revenue (IASB, 2017: para. 86c). The reinsurance held income or expenses should not include finance income or expenses (*ibid*).

If an entity receives amounts from the reinsurer that are not contingent on claims relating to the underlying reinsured contracts, those cash flows should be treated as reductions of the premiums paid to the reinsurer. Reinsurance cash flows that vary according to claims of the reinsured contracts should be treated as part of the reinsurance held claims recoveries (IASB, 2017: para. 86).

The insurance finance income or expenses comprise changes in the carrying amount of insurance liabilities arising from the effect of the time value of money and the changes in financial risk (IASB, 2017: para. 87).

3.5.2 Other comprehensive income under the PAA

IFRS 17 establishes accounting principles for the recognition of insurance items in OCI. The standard allows an accounting policy choice between recognising the entire amount of finance expenses or income in profit or loss (IASB, 2017: para 88a), or recognising the expected amount of insurance finance expense or income in profit or loss and the remainder in OCI (IASB, 2017: para. 88b and 89b).

The expected amount of finance expense or income is the amount determined by allocating the expected total insurance finance expense or income systematically over the coverage period of the group of contracts (IASB, 2017: para. 88b and 89b). If the entity applies the discount rate determined at the reporting date to determine the finance income or expenses, the difference between the total finance income or expenses and the expected amount determined using the systematic allocation of total finance income or expenses over the coverage period, the liability can be recognised in OCI. The entity makes the accounting policy choice on a portfolio by portfolio basis. Because the liability for incurred claims determined under the GMM and the PAA should be similar if the liability has a financing component, the recognition of finance income or expense in OCI is only applicable to the liability for incurred claims under the PAA (IASB, 2017: para. B133).

If an entity that elects to recognise items in OCI transfers or derecognises the insurance contract, a reclassification adjustment is required for the entire remaining balance of OCI relating to the transferred or derecognised insurance contract (IASB, 2017: para. 88b, 90 and 91a). However, that reclassification is not permitted if the finance income or expenses recognised in OCI relate to insurance contracts with direct participation features (IASB, 2017: para. 89b, 90 and 91b).

Table 3.1 illustrates a new format of an insurer's statement of financial performance in terms of IFRS 17.

Table 3.1: Statement of financial performance according to IFRS 17

	20X1	20X0
Insurance revenue (para. 83)		
Insurance service expenses (para. 84)		
Insurance service result before reinsurance held		
Reinsurance held income /(expenses)		
Reinsurance held service result (para. 82 and 86)		
Insurance service result		
Insurance finance income or expenses (para. 88b)		
Profit before tax		
Tax expense		
Profit for the period		
Other Comprehensive income		
Items that may not be reclassified		
Insurance finance income or expenses (para. 89b and 91b)		
Items that may be reclassified		
Insurance finance income or expenses (para. 88b and 91a)		
Reclassification adjustment for derecognition (para. 91)		
Total comprehensive income for the period		

Source: Own construction.

3.6 Disclosure

Based on the information presented in the statement of financial position, the statements of financial performance and the statement of cash flows, IFRS 17 requires the relevant disclosures to be provided in the notes. The reporting entity should disclose information that provides users with a basis for assessing the effect that the recognised insurance contracts have on the entity's financial position, financial performance and cash flows (IASB, 2017: para 93).

IFRS 17 requires an entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the disclosure requirements. Where necessary, IFRS 17 requires the disclosure of additional information necessary to meet the disclosure objectives (IASB, 2017: para 94). In terms of IFRS 17, an entity should apply materiality and aggregation to arrive at the appropriate aggregation bases for insurance contracts so that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics. Appropriate bases for aggregation include the type of insurance contract, geographical area or operating segments (IASB, 2017: para 95 & 96).

The disclosure principles of IFRS 17 are consistent with those established in IFRS 4. IFRS 4 required two disclosure principles, discussed earlier under section 2.3.7, namely the disclosure of information about recognised amounts and the nature and extent of risks arising from recognised insurance contracts. IFRS 17 added a third disclosure principle: the disclosure of qualitative and quantitative information about the significant judgements and changes in those judgements made when applying IFRS 17 (IASB, 2017: para. 93b).

IFRS 17 requires the disaggregation and separate reconciliation of the liability for the remaining coverage and the liability for incurred claims. Under the PAA, the liability for the remaining coverage consists of the unearned premiums less any unamortised insurance acquisition cash flows. An entity should disclose a reconciliation of the opening and closing balances of the liability for the remaining coverage, the liability for incurred claims and the liability for onerous contracts. Disclosures should also provide information about how insurance revenue is determined. The reporting entity is required to disclose the amounts used to determine insurance finance income or expense recognised in profit or loss and the portion recognised in OCI, as well as to provide an explanation for how these amounts were calculated.

The disclosure of significant judgements entails providing the inputs, assumptions and techniques used to measure insurance contracts within the scope of IFRS 17. IFRS 17 requires disclosures about the approaches used to determine the risk adjustment for non-financial risk, the discount rates used and the investment components. An entity is required to disclose the technique used to determine the risk adjustment for non-financial risk if it does not use the confidence level technique (IASB, 2017: para. 119). Additionally, disclosures about the yield curve used to discount the cash flows are required.

An entity is also required to disclose the nature and extent of risks arising from the insurance contracts accounted for under IFRS 17. The entity is required to provide disclosures of the key sources of risk and how these risks are managed. The sources of these risks could be insurance related risks, for example the concentration of insurance risk, or financial risks which include credit risk, market risk and liquidity risks. An insurer is required to disclose the concentration of risks, a sensitivity analysis relating to insurance and market risks and the entity's claims development (IASB, 2017: para. 130).

3.7 Conclusion

This chapter describes the financial reporting aspects of IFRS 17, focusing on short-term insurance contracts. Thus, the focus is on the recognition, modification and derecognition, measurement and disclosure requirements for insurance contracts in terms of IFRS 17.

An issuer should recognise an insurance contract at the earliest of the beginning of the coverage period, the date when the first payment is received from the policyholder or when the contract becomes onerous. In terms of IFRS 17, insurance contracts should be derecognised once the obligations under the insurance contract are extinguished or significantly modified. When this happens, that the initial contract qualifies for derecognition and a new contract with modified terms should be recognised.

IFRS 17 requires insurance contracts to be measured using the general measurement model (GMM) of the Standard, which is based on the fulfilment cash flows and the contractual service margin. The Standard permits the simplification of the GMM for the measurement of simpler or short duration contracts. Using the simplified model, known as the premium allocation approach (PAA), the results of measuring insurance contracts using the PAA should not differ significantly from applying the GMM to the measurement of the same contract.

IFRS 17 requires the separate presentation of insurance assets and liabilities in the statement of financial position. Offsetting of assets and liabilities or reinsurance balances against direct insurance balances is not allowed. In the statements of financial performance, the standard requires the separate presentation of insurance revenue, insurance service expenses, and finance income and expenses, as well as the items that qualify for presentation in OCI. Reinsurance held income or expenses should be presented separately in the statement of financial performance, either as a single net amount or by separately presenting the reinsurance income and reinsurance expenses.

According to IFRS 17 an entity should provide both qualitative and quantitative disclosures about the amounts recognised in the financial statements of the entity that fall under IFRS 17, as well as disclosures about the significant judgements made by management when applying IFRS 17. An entity is required, under IFRS 17, to disclose the nature and extent of risks arising from insurance contracts accounted for under IFRS 17.

The following chapter looks at the assessment of the changes between the current accounting model for short-term insurance contracts and the PAA under IFRS 17.

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Chapter 4. Assessment of IFRS 17: PAA model

4.1 Introduction

This chapter assesses the changes from the current accounting model to IFRS 17. Consistent with the main objective of the research, the focus of the assessment is on contracts that fall under the PAA model. The objective of this assessment is to evaluate the extent to which the PAA model under IFRS 17 improves the accounting treatment of short-term insurance contracts. The current accounting model will be replaced by IFRS 17 for annual reporting periods beginning on or after 1 January 2021 (IASB, 2017).

Short-term insurance contracts in South Africa are defined in the STI Act (South Africa, 1998: sec. 1). IFRS 17 has two models for accounting for insurance contracts, the GMM and the PAA. IFRS 17 does not establish a model specifically for all short-term insurance contracts defined in the STI Act, but establishes principles to determine the appropriate model for each group of similar insurance contracts entered into at or about the same time. In terms of IFRS 17, contracts that are issued more than one year apart should not be included in the same group (IASB, 2017: para 22). Short-term insurers will apply one of the two models for each group of insurance contracts, according to the requirements of IFRS 17.

The GMM and the PAA are similar in all aspects except the measurement approach under the PAA, which is an operational simplification. An entity can choose, but is not required, to apply the PAA if the results of measuring the contracts using the PAA approximate the GMM or if the coverage period of the group of contracts does not exceed one year (IASB, 2017: para. 53 and BC291).

IFRS 17 changes the way insurance contracts are classified for the purpose of measurement. In the current accounting model, insurance contracts are classified as short-term, long-term or medical schemes according to South African insurance legislation. Under IFRS 17, insurance contracts are not classified. Rather, IFRS 17 has a principle based measurement model, the GMM, which can be simplified to the PAA if the PAA eligibility criteria are met. Short-term insurers, for example, may end up with certain contracts that qualify for the measurement using the PAA model and others that do not.

4.2 Assessment criteria

For purposes of this research, the following criteria will be used to assess the solutions provided by IFRS 17 to the deficiencies under the current accounting model. One of the reasons for issuing IFRS 17 was to get rid of the diverse accounting practices for insurance contracts across jurisdictions, as the accounting requirements often reflected the requirements of various national regulators (IASB, 2017: para. IN4). The differences in accounting treatment for insurance contracts across jurisdictions and products made it difficult for investors and analysts to understand and compare insurers' results (*.ibid*).

This assessment does not test the quality of the guidance contained in IFRS 17, but rather the existence of the accounting guidance, which in turn provides preparers of financial statements, lenders, investors, analysts and regulators with a common source of guidance for consistency and comparability of the financial statements of insurers. Table 4.1 sets out the assessment criteria applicable to this chapter.

Table 4.1: Assessment criteria

Current accounting model	**PAA under IFRS 17**	**Assessment**
No accounting guidance	New accounting guidance	Improvement
No accounting guidance	No new guidance but refers to an existing standard	Clarification
Existing accounting guidance	Clarification of existing accounting guidance, with additional guidance	Clarification / Improvement
Existing accounting guidance	No accounting guidance	Retrogression
Existing accounting guidance	Existing accounting guidance retained	Neutral
Existing accounting guidance	New accounting guidance replaces the existing guidance	These changes are not assessed in this research.

Source: Own construction

All aspects of the financial reporting for short-term insurers will be assessed below, from initial recognition, measurement, modification and derecognition through to presentation and disclosure.

4.3 Initial recognition

Section 2.4 discussed the current accounting requirements for the recognition and measurement of short-term insurance contracts in terms the Circular. Section 3.2.1 discussed the initial recognition requirements of IFRS 17. The Circular is silent about initial recognition. Secondly, it treats the various cash flow components (premiums, claims, commission and balances) of insurance contracts as separate units of account, whereas IFRS 17 treats the entire insurance contract as a unit of account. Hence, IFRS 17 addresses the initial recognition of the entire contract.

IFRS 17 improves the timing of initial recognition of insurance contracts because it provides clearer guidance relating to when a contract should be recognised. In many instances, the first insurance premium is due at the beginning of the coverage period (IASB, 2017: para. BC141). However, in terms of the current accounting model, initial recognition occurs during the underwriting year in which the policy incepts. The Circular does not provide additional guidance of when the policy incepts. Therefore, IFRS 17 clarifies the requirements for the timing of initial recognition of insurance contracts, which is an improvement.

Additionally, IFRS 17 requires an entity to determine if a contract is onerous on initial recognition. If so, the contract qualifies for recognition at that time in order to recognise the anticipated loss. The current accounting model does not include this requirement on initial recognition. This additional requirement improves the faithful presentation and relevance of insurance contracts on initial recognition, compared to the current model.

4.4 Modification and derecognition

This section assesses the modification and derecognition requirements of the current accounting model and IFRS 17.

4.4.1 Modification

IFRS 17 establishes the accounting principles for the modification of insurance contracts as discussed under section 3.2.2. Substantial modification of contracts can result in the derecognition of the existing contract and recognition of a new contract with the modified terms. This is not the same as the current accounting model, which is silent about the accounting approach when contracts are modified. In particular, IFRS 4 does not address the modification of insurance contracts at all. Therefore, IFRS 17 improves the accounting treatment of contracts when modification of the original terms of a contract occurs. The improvement arises from the new guidance that is not available under the existing accounting model.

4.4.2 Derecognition

In terms of the discussion under 2.3.5, IFRS 4 requires the derecognition of an insurance liability when the obligation specified in the contract is discharged or cancelled or expires (IASB, 2004: para. 14c). IFRS 4 is silent about the derecognition of insurance and reinsurance assets (IASB, 2004: para. BC105). Therefore, the derecognition of insurance assets is an integral part of the measurement of these assets. For example, the requirement to test insurance and reinsurance assets for impairment results in writing off amounts that are not recoverable (SAICA, 2007: para. 35; IASB, 2004: para. 20).

As discussed under section 3.2.2, should be derecognised when the obligations specified in the contract is discharged or cancelled or expires. IFRS 17 improves the derecognition principles for insurance contracts by extending the requirements from insurance liabilities, as required by IFRS 4, to the entire contract. Thus, IFRS 17 has accounting requirements for the derecognition of a contract, compared to the existing model which has derecognition requirements for insurance liabilities only.

4.5 Cash flows within the contract boundary

The contract boundary is a new concept introduced by IFRS 17 and discussed in section 3.3.1. On initial recognition of a short-term insurance contract, it may not be possible to establish when the contract boundary ends. This happens for example due to the uncertainties regarding the timing of the events that may lead to the reassessment of risks, depending on the terms and conditions of the insurance contract. In terms of IFRS 17, entity should review estimates annually, so that the cash flow estimates included in the measurement of contracts are current (IASB, 2017: para 33c & B54).

The current accounting model does not define the contract boundary. The current model requires the insurance premiums and acquisition costs to be spread over the coverage period of the premiums. In practice, the period of risk covered by a policy is the period for which premiums have been paid by the policyholder. For example, monthly premiums should be fully recognised as revenue earned at the end of the month, and the same applies to quarterly or annual premiums. Generally, there is no consideration of the period beyond the term covered by the premiums received, unless the insurance contract has a fixed term. Under this approach, only contracts for which premiums have been paid are recognised in the financial statements, for the period covered by those paid up premiums.

The Discussion Paper*: Preliminary Views On Insurance Contracts* suggests that a lifelong insurance contract with an annual cancellation option should be treated in the same way as a contract with only a one year coverage period (IASB, 2007: para. 152; Nguyen & Molinari, 2013). The views expressed in the Discussion Paper are similar to the way the current accounting model works. However these views have been abandoned and IFRS 17 has new requirements for the determination of contract boundaries, discussed in section 3.3.1.

The establishment of principles for the determination of contract boundaries in IFRS 17 is an improvement compared to the current accounting model, which is silent on how to determine a contract's boundaries. Although IFRS 17 clarifies the contract boundaries, the determination of contract boundaries for short-term insurance contracts issued for indefinite periods requires significant judgement.

4.6 Application of the PAA to existing insurance contracts

IFRS 17 permits an entity to apply the PAA if measuring the insurance contracts using the PAA produces results that do not differ significantly from the results obtained by applying the GMM. There is a presumption that this requirement will be achieved if the coverage period of the insurance contract does not exceed one year (IASB, 2017: para. 53a and BC291).

Hence, the PAA is intended for short-term contracts and contracts that are simple to measure, if they are not regarded as short-term with reference to the length of their coverage periods. Short-term is regarded as a coverage period of one year or less, as implied in the operational simplification of IFRS 17. The operational simplification permits an entity to apply the PAA without further investigation when the coverage period of the group of contracts does not exceed one year (IASB, 2017: para 53b).

Other contracts that have coverage periods exceeding one year are also eligible for measurement using the PAA if they are not subject to measurement uncertainties arising from either longer coverage periods or the presence of embedded derivatives in the contracts. Longer coverage periods or the presence of embedded derivatives may lead to significant variability of the fulfilment cash flows, which may result in measurement uncertainty of the liability for the remaining coverage, before claims are incurred. Contracts that do not have characteristics which cause measurement uncertainty are eligible for measurement using the PAA (IASB, 2017: para. 54).

The one year operational simplification of IFRS 17 is similar to the approach followed under the current accounting model. The coverage period for short-term insurance contracts is not defined under the current accounting model. However, according to the VAT 421 *Guide for short-term insurance*, short-term insurance is for a period of one year and is renewable annually at the option of the insured. It can also be for an unspecified (indefinite) period (SARS, 2013).

The current accounting model also accommodates insurance contracts with coverage periods of longer than a year in short-term insurance because short-term insurance policies are listed in the STI Act. According to the Act, "short-term policy" means an engineering policy, guarantee policy, liability policy, miscellaneous policy, motor policy, accident and health policy, property policy or transportation policy, including any combination or renewals of such contracts (South Africa, 1998). An entity should use judgement when deciding on the length of the coverage period that makes a contract ineligible for the PAA.

Therefore, short-term insurance contracts currently issued by South African entities which do not have embedded derivatives could be eligible for measurement under the PAA, provided the measurement results do not differ significantly from the results achieved by measuring the contracts using the GMM, or the coverage period of the contract is a year or less.

IFRS 17 states that an entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17 (IASB, 2017: para. 2). Although IFRS 17 is silent about the premium payment intervals, the terms and conditions of the contract should be applied to determine the coverage period of the contract when non-payment of premiums by the policyholder leads to an automatic contract cancellation by the issuer at no cost. IFRS 17 states that the contract boundary ends when the entity has the practical ability to reassess the insurance risk and reprice the insurance contract (IASB, 2017: para. 34), but ignores a key factor regarding whether or not any party is bound by the contract after the payment interval expires. If either party can walk away from the contract after the expiry of such an interval, then the reassessment of risks is not the only factor that determines when the contract boundary ends.

Short-term insurance contracts issued for coverage periods of one year or less qualify for measurement using the PAA. It is subjective to ascertain if contracts issued for indefinite periods qualify for the PAA model as IFRS 17 does not provide sufficient linkage between these indefinite periods and the insurer's substantive rights to reassess the insurance risks and reprice the insurance contract to reflect those risks, marking the end of the contract boundary.

IFRS 17 permits certain contracts with coverage periods exceeding one year to be measured using the PAA model, provided the measurement results do not differ significantly from the results of the GMM. However, IFRS 17 does not provide sufficient guidance on what constitutes significant difference in measurement. As such, similar contracts could be accounted for differently by different entities depending on their judgement of when the measurement results differ significantly between the GMM and the PAA.

4.7 Liability for the remaining coverage

The liability for the remaining coverage is the entity's obligation to investigate and settle valid claims for insured events that have not yet occurred under insurance contracts issued by the entity. This obligation relates to the remaining portion of the insurance coverage at the reporting date (IASB, 2017). The objective of this section is to assess the changes in the measurement models between the current accounting model and the PAA under IFRS 17.

4.7.1 Initial measurement of liability for remaining coverage

Under the PAA, the liability for the remaining coverage is initially measured at the amount of the premium received from the policyholder. If the entity elects to defer insurance acquisition cash flows, this amount should be deducted from the premiums received to determine the liability for the remaining coverage. Additionally, if there is a precoverage asset for insurance acquisition cash flows recognised before the initial recognition of the group, the asset should be derecognised and included in the initial measurement of the group of insurance contracts (IASB, 2017: para. 55a(i) and 55b(i)).

The current accounting model requires an entity to recognise gross written premiums on the initial recognition of a contract. These premiums are for the entire coverage period, regardless of when payment of the premiums falls due (SAICA, 2007). Although not explicitly stated in the Circular, it appears that these gross premiums are initially recognised as revenue and, at the reporting date, the unearned portion is determined and transferred to liabilities in the form of UPP. Revenue for the period is the gross written premiums adjusted for the movement in the UPP. The unearned portion of gross premiums at the reporting date should be transferred to insurance liabilities.

By requiring the recognition of gross written premiums regardless of the timing of payment of the insurance premiums (SAICA, 2007: para. 11 and 16), the current model implies the recognition of a receivable for the premiums and a liability for unearned premiums on initial recognition, a practice avoided by many insurers who resort to recognising only contracts for which premiums have been paid. This practice is similar to the cash basis of accounting, which is neither a requirement of the Circular nor IFRS 4. Lapses and adjustments (SAICA, 2007: para. 18–20) automatically remove unpaid premiums from the scope of recognition of the unearned premiums liability.

The current accounting model does not specifically state that a liability should be raised for the premiums received on the initial recognition of gross written premiums. Furthermore, it is unclear under the current accounting model if a liability should be raised before the premiums are received from the policyholder. A self-correcting perspective of the current model is that to the extent that premiums are unpaid on contract inception, written premiums receivables and the UPP are combined in the measurement of the contract, resulting in a nil value on initial recognition of the contract. However because UPP and insurance assets are recognised separately under the current model, the initial recognition requirements are unclear.

Comparing the two models, the initial recognition requirements of IFRS 17 are significantly clarified and improved because the liability for the remaining coverage is only recognised for premiums that have been received by the insurer.

4.7.2 Subsequent measurement of liability for remaining coverage

Under the PAA, the liability for remaining coverage is measured by deducting the portion attributed to the expired periods from the liability of the remaining coverage recognised at the beginning of the reporting period. After the measurement at initial recognition, the opening balance of the liability should be adjusted for:

- the premiums received during the period,
- the accretion of interest for contracts with a significant financing component,
- insurance acquisition cash flows that are not expensed,
- adjustments for the amount recognised as insurance revenue for coverage provided in that period, and
- adjustments for the investment component transferred to the liability for incurred claims or paid (IASB, 2017: para. 55).

An example of an investment component is a cash back component that is not separated from the host insurance contract because of the level of interdependence between the cash back component and insurance services within the contract. The current accounting model requires the cash back component to be treated as part of UPP, which is the same approach that could be followed under IFRS 17 since there is no specific guidance for cash back components in the new standard.

Under the current model, short-term insurance transactions are accounted for on a deferral and matching basis (Ernst & Young, 2013). The current accounting model requires the recognition of gross written premiums and the deferral of the unearned portion as an insurance liability. In terms of the Circular, premiums written in the current accounting period should be treated as earned premiums except to the extent that they relate to unexpired periods of risk at the reporting date (SAICA, 2007: para. 11 and 23). That is, at the reporting date, unearned premiums should be measured and transferred to insurance liabilities.

According to IFRS 17, an entity should discount the liability for the remaining coverage. However, if there is an expectation at initial recognition that the time between providing each part of the insurance cover and the related premium due date does not exceed one year, there is no requirement to discount the liability for the remaining coverage (IASB, 2017: para. 56). In South Africa, the general practice is that insurance premiums for direct insurance contracts are payable in advance, hence most short-term contracts are unlikely to be discounted because the contracts do not have significant financing components.

Some reinsurance contracts issued require the payment of deposit premiums by the policyholder, which are also advance payments which need not be discounted according to the requirements of IFRS 17. However, other reinsurance contracts require payments to be made only after the submission of reinsurance accounts, based on the reinsurance service result for that specific period. When the premiums are payable after more than a year, the entity should discount the liability for the remaining coverage.

Under the current model, the discounting of insurance liabilities depends on the reporting entity's circumstances. An entity that measured insurance liabilities on an undiscounted basis prior to the adoption of IFRS 4 is permitted to continue measuring its liabilities on that basis. However IFRS 4 prohibits the introduction of this practice after adoption of the standard (IASB, 2004: para. 25). The Circular is silent on the discounting of insurance liabilities. The guidance provided under APN 401 requires insurance liabilities to be measured on a discounted basis. Insurers who follow this guidance would therefore report insurance liabilities measured on a discounted basis in their financial statements.

IFRS 17 requires an entity to determine if the insurance contracts it has issued have become onerous by comparing the carrying amount of the liability for the remaining coverage determined using the PAA and the liability determined by applying the GMM. If the amount measured according to the GMM exceeds the amount determined by applying the PAA, the entity should recognise a loss in profit or loss and increase the liability for remaining coverage (IASB, 2017: para. 57–58).

Under the current model, IFRS 4 requires an insurer to perform a liability adequacy test and apply IAS 37 to determine whether the issued contracts are onerous (IASB, 2004: para. B7). In terms of the Circular, an entity should determine the unexpired risks provision by comparing the expected value of UPP less DAC to the expected value of claims and expenses over the coverage period. If the expected value of claims and expenses is higher, the difference should be recognised as an expense in profit or loss (SAICA, 2007: para. 40).

The treatment of acquisition costs under IFRS 17 affects the measurement of the liability for the remaining coverage. Insurance acquisition cash flows should be included in the measurement of the liability for the remaining coverage, unless the entity elects to write them off when incurred (IASB, 2017: para. 59a).

Under the current accounting model, acquisition costs are capitalised and amortised over the risk period. These costs do not affect the measurement of UPP, except when the entity performs the liability adequacy test. In terms of IFRS 4, the liability adequacy test should be performed annually by deducting DAC and related intangible assets from insurance liabilities, and determining if the liabilities are sufficient to cover the entities' obligations to pay expected claims. Any resulting deficiency should be recognised in profit or loss (IASB, 2004: para 15).

Under the PAA, the IASB has clarified the treatment of insurance acquisition cash flows when discounting is required as well as how to determine when a group of contracts is onerous. The current model does not have sufficient guidance on these matters, for example the numerous conditions for discounting under IFRS 4 may lead to measurement inconsistencies across entities. IFRS 17 improves the measurement of the liability for the remaining coverage by requiring a consistent approach for all contracts and by clarifying when an entity can use the PAA to simplify the measurement of the liability for the remaining coverage.

4.7.3 *Investment components*

An investment component is the amount that an entity is required to refund to a policyholder, even if the insured event does not occur. IFRS 17 requires an entity to separate distinct investment components from insurance contracts and account for them under IFRS 9. If the investment component has cash flows that are highly interrelated with those of the insurance contract, IFRS 17 should be applied to account for those cash flows (IASB, 2017).

According to IFRS 17, if the value of one component varies according to the value of the other, an entity should apply IFRS 17 to account for both the investment and the insurance components. Additionally, an investment component is not distinct if the policyholder is unable to benefit from one component unless the other is also present. For example, if the lapse or maturity of the insurance component in a contract causes the lapse or maturity of the investment component, the investment component is not distinct and the entity should apply IFRS 17 to account for the combined contract (IASB, 2017: para. B32).

The investment component that is not separated from the host insurance contract falls within the scope of IFRS 17 (IASB, 2017: para. 13). On initial recognition, IFRS 17 is silent about the splitting of premiums received when recognising the liability for the remaining coverage (IASB, 2017: para. 55a). Therefore the non-distinct investment component should be recognised initially as part of the liability for the remaining coverage, together with the premiums received for the insurance component.

IFRS 17 provides for situations when the investment component should be transferred from the liability for the remaining coverage to the liability for incurred claims. Although there is no explanation of this transfer in IFRS 17, it is assumed that only the vested investment component should be transferred to the claims liability. This transfer should not affect the insurance portion, i.e. in principle the vesting of the investment component does not give rise to insurance revenue or insurance service expenses, unless there is a change in estimate of the vested amount.

According to IFRS 17, investment components that are not separated from the host contracts are not recognised in the statements of financial performance because the premiums allocated to the investment component are initially recognised as a liability and not as revenue, and the repayment of that investment component is regarded as a repayment of premiums that are not recognised as claims incurred (IASB, 2017: para. 84 and 85).

Because the non-distinct investment component is interrelated with the insurance component, there could be adjustments between the insurance and the investment components at each reporting date. The interrelationship arises from the fact that the repayment of the investment component depends on one or more conditions in the contract (IASB, 2017: para. B32b), such as the non-registration of claims in the case of claim free bonuses. When the repayment conditions are satisfied, the entity should transfer the vested portion from the liability for the remaining coverage to the liability for incurred claims (IASB, 2017: para. 55b(iv)).

IFRS 4 refers to deposit components, while IFRS 17 refers to investment components when the contract requires some form of repayment of premiums back to the policyholder. Under the current accounting model, IFRS 4 requires the unbundling of the deposit component from the host insurance contract if the deposit component can be measured separately and the insurer's accounting policies do not require it to account for the deposit component separately. The unbundled deposit components should be accounted for as financial liabilities in terms of IFRS 9 (IASB, 2004: para. 12b).

If the entity's accounting policies require it to recognise all rights and obligations arising from the deposit component, unbundling the deposit component is permitted but not required. If the deposit component cannot be measured reliably, unbundling is not permitted (IASB, 2004: para. 10). The deposit components that are not unbundled should be accounted for as insurance components (IASB, 2004: para. 12a) and included in the UPP (ASSA, 2013: APN401 para. 3.2.5). The premiums received by the insurer that are allocated to the deposit component should not be recognised as revenue, but as changes in the deposit liability (IASB, 2004: para. BC41c) or the unearned premium provision, if not unbundled from the host contract.

Under IFRS 17, an entity should separate only the distinct investment components from the host and apply the requirements of IFRS 9 to account for these components. IFRS 17 clarifies the accounting requirements for investment components and removes the various options available for deposit components under IFRS 4. The significant change between the two models is that IFRS 4 ignores the fact that the deposit component could be highly interrelated with the insurance component such that unbundling the two components does not achieve a faithful representation of the insurance contract. This situation improves under IFRS 17, which requires the separation of investment components that are distinct.

4.8 Subsequent measurement – The liability for incurred claims

IFRS 17 requires an entity to recognise the liability for incurred claims at the sum of fulfilment cash flows relating to past services (IASB, 2017: para. 40b). These fulfilment cash flows include estimates for claims and administration expenses incurred but not yet settled (IASB, 2017: para. BC25).

4.8.1 Measurement of liability for incurred claims

The liability for incurred claims should only be recognised once the insured events have occurred, including the IBNR claims liability. Hence, at initial recognition of an insurance contract, the liability for incurred claims is zero (IASB, 2017: para. BC295). When the insured events occur, the liability should be measured at the amount of the expected fulfilment cash flows required to settle the liability for the incurred losses.

Under the current accounting model, the Circular requires an entity to make a provision for the expected ultimate cost of settling all claims outstanding at the reporting date. The provision should also incorporate the related claims handling expenses and the IBNR claims provision (SAICA, 2007: para. 26–28). There is uncertainty involved in setting these provisions, hence the Circular requires the entity exercise prudence when measuring the provisions to avoid understating the liabilities (SAICA, 2007: para. 32). Even if the entity measured its liabilities with excessive prudence on the initial adoption of IFRS 4 in 2005, IFRS 4 does not require the entity to change this accounting policy. However, the introduction of additional prudence to the measurement of insurance liabilities that are already measured with sufficient prudence is not allowed under IFRS 4 (IASB, 2004: para. 26).

Both the current accounting model and IFRS 17 require an entity to determine the IBNR claims liability. Both models do not provide measurement techniques for this component of the liability for incurred claims. The Circular requires IBNR to be based on statistical or other techniques that incorporate uncertainties due to the timing differences between the occurrence of insured incidents and the reporting of those events to the insurer (SAICA, 2007). Entities are most likely to continue measuring IBNR claims liabilities based on their current practices.

According to IFRS 17, an entity should discount the fulfilment cash flows for the liability for incurred claims. However, if an entity applies the PAA, IFRS 17 does not require the adjustment of the fulfilment cash flows for the time value of money and financial risk if the claims and expenses are expected to be settled within one year from the date incurred (IASB, 2017: para 59b). If the liability for incurred claims has a significant financing component, i.e. settlement is expected after more than one year from the loss date, it should be discounted at a rate determined on initial recognition of the liability (IASB, 2017: para. BC295).

Due to the measurement uncertainties relating to the timing or amounts of incurred claims, the measurement of the liability for incurred claims should incorporate a risk adjustment for non-financial risk (IASB, 2017: para. 37 and 100c). At each reporting date, the fulfilment cash flows for the liability for incurred claims should be adjusted to current estimates. This procedure removes the need to perform the liability adequacy test, which is a requirement of IFRS 4 (IASB, 2017: para. 33c and BC20).

The current accounting model for short-term insurance does not require the discounting of claims liabilities if the insurer has always measured its liabilities at undiscounted values. However IFRS 4 does not permit changing the accounting policies that require discounting to those that do not (IASB, 2004: para. 25). APN 401, which has been adopted by some insurers, requires the discounting of insurance liabilities if the average contract duration exceeds four years (ASSA, 2013: para. 3.9.1). However, the general practice is to measure short-term insurance liabilities at undiscounted values.

The components of the liability for incurred claims are similar under both the current accounting model and IFRS 17, except for the risk adjustment for non-financial risk. These are the incurred claims not yet paid, the related claims handling expenses and

IBNR claims. In addition to these components, IFRS 17 requires the inclusion of a risk adjustment for non-financial risk when measuring the liability for incurred claims. The current accounting model requires an entity to incorporate prudence when measuring the liability for incurred claim in order to address the measurement uncertainties about the timing and amounts of the ultimate cash flows. Prudence is not separately quantified under IFRS 4, but under IFRS 17 the risk adjustment for non-financial risk is a separate component of the liability for incurred claims.

By requiring a separate component for the risk adjustment in the measurement of the liability of incurred claims, IFRS 17 improves the way uncertainties about the ultimate cash flows for incurred claims are incorporated in the measurement of the liability. Under the current model, prudence, which addresses uncertainties, is not separately quantified. Additionally, the current model permits overstating liabilities by way of allowing entities to continue incorporating excessive prudence if liabilities were always measured with such prudence before adopting IFRS 4. Such a measure is not neutral and could affect the faithful representation of the recognised insurance liability.

IFRS 17 is an improvement regarding the measurement of insurance liabilities because it only requires estimates to be updated to reflect the current estimates of expected fulfilment cash flows to determine the sufficiency of the liabilities. This requirement replaces two aspects under the current accounting model: the liability adequacy test and the unexpired provision test. Therefore, the liability adequacy test and the unexpired risk reserve are no longer required.

4.8.2 The risk adjustment for non-financial risk

When IFRS 4 was issued, the requirements to discount insurance liabilities and to adjust for non-financial risks were deferred to Phase II of the insurance project (IASB, 2004: para. BC126). The Circular requires an entity to incorporate prudence when insurance liabilities are measured under conditions of uncertainty (SAICA, 2007: para. 32-33). If an insurer incurs an underwriting loss during any reporting period, the Circular requires the entity to determine the unexpired risks provision and include this amount in its insurance liabilities.

Although risk adjustments are not specifically identifiable in the determination of IBNR for regulatory reporting, the Board Notice requires an entity to incorporate risk adjustments when determining and reporting solvency capital requirements to the regulator (South Africa, 2011; FCSA, 2016). Although the current model has some mechanisms to incorporate non-financial risks in the measurement of insurance liabilities, the there is no specific method to determine these risks. Some of the risks determined for solvency purposes may also not be relevant for financial reporting, for example market, credit and insurance risk capital charges required when determining capital adequacy for solvency purposes (FSCA, 2015).

IFRS 17 improves the way uncertainties are incorporated in the measurement of insurance liabilities because a risk adjustment, being a separate component of the insurance liability, provides more information than “prudence” or unexpired risk reserve for which there is no consistent method of measuring these components of insurance liabilities. IFRS 17 specifically requires the use the confidence level to determine the risk adjustment for non-financial risk.

4.9 PAA applicable to reinsurance contracts held

IFRS 17 defines a reinsurance contract as an insurance contract issued by one entity to compensate another entity for claims arising from one or more insurance contract issued by that other entity (IASB, 2017: Appendix A). The reporting entity is a policyholder in a reinsurance contract held. This is a special inclusion in the scope of IFRS 17 because insurance contracts in which the entity is a policyholder, other than reinsurance contracts held, are outside the scope of IFRS 17 (IASB, 2017: para. 7g).

In terms of IFRS 17, an entity may use the PAA for reinsurance contracts held if the entity reasonably expects that the resulting measurement would not differ materially from the result of applying the GMM, or the coverage period of each contract in the group of reinsurance contracts held is one year or less (IASB, 2017: para. 69). When the fulfilment cash flows are subject to significant variability due to the length of the coverage period or embedded derivatives, the PAA should not be used because the measurement results between the PAA and the GMM could differ significantly (IASB, 2017: para. 70).

The assessment of the application of the PAA for reinsurance contracts held should be performed independently of the measurement approach adopted for the underlying direct insurance contracts. This is due to the fact that IFRS 17 does not make reference to the measurement approach adopted for direct insurance contracts when deciding on the measurement approach for reinsurance contracts held.

IFRS 17 requires proportional reinsurance contracts held to be recognised on initial recognition of the underlying direct insurance contracts or, if later, at the beginning of the reinsurance coverage period. IFRS 17 requires non-proportional reinsurance contracts to be recognised from the beginning of the reinsurance coverage period (IASB, 2017: para. 62). Under proportional reinsurance, the insurer shares a predetermined share of insurance revenue and service expenses with the reinsurer. Under non-proportional reinsurance, the reinsurer compensates the insurer for losses exceeding predetermined amounts in return for premiums agreed between the two parties.

IFRS 17 requires the same recognition and measurement approach applied to insurance contracts to be applied to reinsurance contracts held. However, the accounting requirements for reinsurance contracts held should be modified to reflect the fact that reinsurance contracts held are generally assets, rather than liabilities. Accordingly, in terms of IFRS 17, a reinsurance contract held cannot become onerous (IASB, 2017: para. 68). Onerous contract requirements are specifically designed for liabilities. These requirements cannot be applied to assets. Instead, assets can become impaired. Hence, IFRS 17 requires the estimates of future cash flows under the reinsurance contract held to incorporate the risk of default by the reinsurer, taking into account collateral (IASB, 2017: para. 63).

The reinsurance accounting requirements described above have been significantly clarified under IFRS 17 compared to the current accounting model. The clarification is that the reinsurance accounting requirements relate specifically to reinsurance contracts held. A reinsurance contract is a type of insurance contract; consequently, the IASB found no reason to apply different accounting requirements to reinsurance contracts issued from those applied to direct insurance contracts issued by the entity (IASB, 2017: para. 3a and BC296).

Secondly, IFRS 17 clarifies the accounting requirements for reinsurance contracts held. In terms of the standard, the PAA for insurance contracts issued should be modified when accounting for reinsurance contracts held to reflect the fact that reinsurance contracts held are generally assets and that the intention of taking out reinsurance is not to make profit. The current model does not specify these differences and reinsurance issued and reinsurance held are generally accounted for as mirror images of each other.

IFRS 17 does not have a comprehensive impairment model for reinsurance assets. The only measurement requirement relevant to impairment in IFRS 17 is that the entity should consider the effect of default by the issuer of the reinsurance contract, taking into account the collateral in place and the financial effect of potential disputes (IASB, 2017: para. 63). IFRS 9 is silent about the impairment of insurance or reinsurance assets. Under the current model, IFRS 4 specifically requires reinsurance assets to be impaired if there is objective evidence of the impairment (IASB, 2004: para. 20). Hence IFRS 17 offers no improvement or clarification on the impairment of reinsurance assets.

4.10 Revenue

Most short-term insurance contracts qualify for measurement using the PAA approach. In terms of the PAA, insurance revenue for the period is the amount of expected insurance premiums systematically allocated over the coverage period. The expected premiums should be allocated over the coverage period either on the basis of the passage of time, or on the basis of the expected timing of incurred insurance service expenses, if the expected pattern of release of risk during the coverage period differs significantly from the passage of time (IASB, 2017: para. B126).

Under the current accounting model, revenue recognition is a function of two elements: gross written premiums and the change in the UPP. The net of written premiums and the change in UPP constitute earned premiums, which equate to the revenue for the period. In terms of the Circular, revenue should be recognised over the coverage period on the basis of passage of time or in accordance with the pattern of the incidence of risk if the passage of time basis provides a materially different outcome from the risk pattern (SAICA, 2007: para. 22).

The revenue recognition model under the current accounting model is consistent with IFRS 17, with a few exceptions. For example, under the current accounting model, specifically in terms of the annual return of the FSCA presented in Table 2.5, net earned premium revenue is obtained after deducting reinsurance held premiums from earned premiums. IFRS 17 does not permit the offsetting of reinsurance held premiums against insurance revenue (IASB, 2017: para. 82). IFRS 4 has a similar requirement that prohibits the offsetting of revenue against reinsurance premium expenses (IASB, 2004: para. IG24a).

IFRS 17 adopts the asset-liability approach to revenue recognition, which requires revenue to be determined on the basis of the change in the liability for the remaining coverage, excluding the investment and financing components (IASB, 2017: para. 55b(v)). IFRS 17 improves revenue recognition and presentation by requiring the separate presentation of insurance revenue, reinsurance held premiums and investment components. Investment components that are not separated from the host contracts should be presented separately in the statement of profit or loss (IASB, 2017: para. 85).

IFRS 4 provides guidance on the unbundling of deposit components in insurance contracts. In terms of the standard, deposit components should be unbundled when they can be measured and if the entity does not already account for them separately. The unbundled components should be accounted for as financial liabilities under IFRS 9. IFRS 4 does not permit the recognition of premium receipts allocated to the deposit components as revenue, but rather as a change in the deposit liability (IASB, 2004: para. BC41c).

The improvements to the revenue recognition under IFRS 17 compared to the current accounting model can be summarised as follows:

- Alignment with IFRS 15,
- Presentation guidance for insurance revenue, including
    - the presentation of earned premium revenue as a single line item, excluding the premiums allocated to non-distinct investment components,
    - the replacement of written premiums by earned insurance revenue in the statement of profit or loss, and

- the separate presentation of reinsurance held premium adjustments from insurance revenue.

These factors improve the comparability of revenue recognition and presentation for insurers and non-insurers.

4.11 Insurance acquisition cash flows

An entity incurs acquisition cash flows as part of its efforts to secure business from existing or potential clients. According to IFRS 17, insurance acquisition cash flows are cash flows arising from the costs of selling, underwriting and initiating a portfolio of insurance contracts (IASB, 2017: Appendix A). The cash flows include cash flows that are not directly attributable to the acquisition of every single insurance contract but directly attributable to the portfolio of insurance contracts to which the individual contracts belong (*ibid.*).

IFRS 17 has specific accounting requirements for pre-coverage insurance acquisition cash flows. According to IFRS 17, if an entity pays or receives amounts relating to insurance acquisition cash flows before the group of contracts is recognised, it should recognise an asset or liability for those cash flows, unless the entity elects to write off the acquisition cash flows immediately in terms of the accounting policy choice under the PAA. The asset or liability should be derecognised and allocated to the fulfilment cash flows on initial recognition of the insurance contract (IASB, 2017: para. 27).

When an entity applies the PAA, there is an accounting policy choice of either including the insurance acquisition cash flows in the measurement of the insurance liability on initial recognition, or expensing these cash flows when incurred if the coverage period of the contract or group of contracts is less than a year (IASB, 2017: para. 59a). IFRS 17 does not permit separate capitalisation of deferred insurance acquisition cash flows, except when the acquisition costs are incurred before the group of contracts is recognised (IASB, 2017: para. 27). The IASB notes that the entity typically charges the policyholder a price the entity regards as sufficient to compensate it for the cost of originating the contracts and for undertaking the obligation to pay for insured losses. The Board provided the following reasons against the separate capitalisation of DAC:

- There is existence uncertainty of the asset if the economic benefits relating to the asset are the premiums that the entity has already received, or
- There is existence uncertainty of the asset if the cash flows relating to the asset are included in the measurement of the contract, or
- The liability for the remaining coverage should relate only to insured events, and should exclude costs of originating the insurance contracts (IASB, 2017: para. BC176).

Liu and Liao (2016) made a compelling argument for the separate capitalisation of insurance acquisition cash flows. They argue that incurring insurance acquisition cash flows could result in future economic benefits in the form of policy renewals, resulting in more premiums for the entity in the future. According to this view, it is appropriate to create assets for insurance acquisition cash flows when they are paid. However, Liu and Liao (2016) did not demonstrate that the potential policy renewals represent a right held by the entity, which the entity controls.

In terms of the current accounting model, IFRS 4 is silent about the accounting treatment of acquisition costs (IASB, 2004: para. BC116). The Circular requires the deferral of acquisition costs and allows for them to be written off systematically (SAICA, 2007: para. 48). IFRS 4 does not specify whether a DAC asset should be created or if the DAC should be offset against insurance liabilities. Although IFRS 4 does not specifically require the inclusion of DAC in the measurement of insurance liabilities, the liability adequacy test requires the reduction of insurance liabilities by the DAC and related intangible assets when determining the sufficiency of insurance liabilities at a specific date.

IFRS 17 improves the accounting for insurance acquisition costs by clarifying the accounting requirements. Insurance acquisition cash flows, under IFRS 17, should be included in the measurement of the insurance liabilities or expensed if the coverage period is less than a year (IASB, 2017). If not expensed, IFRS 17 requires the inclusion of the insurance acquisition cash flows in the measurement of the liability for the remaining coverage because groups of insurance contracts are units of account which give rise to a single asset or liability from the combined rights and obligations arising from the contracts (IASB, 2017: para. BC139).

4.12 Insurance service expenses

Insurance service expenses under IFRS 17 relate to claims incurred during the period including revisions to previous estimates of the liability for incurred claims, the amortisation of insurance acquisition cash flows and losses arising from onerous groups of insurance contracts. These expenses are primarily derived from changes in the insurance liabilities. Under the PAA, an entity should recognise insurance service expenses for the change in the liability for incurred claims because of claims and claims handling expenses incurred in the reporting period, excluding investment and financing components (IASB, 2017: para. 42 and 59b).

Subsequent adjustments to the estimates of fulfilment cash flows for the liability for incurred claims should also be recognised as insurance service expenses, unless they relate to finance costs. For example, adjustments to the cost of claims should be included in the insurance service expenses as claims incurred. Other insurance service expenses include the amortisation of insurance acquisition cash flows, and losses on onerous contracts, including reversals of such losses (IASB, 2017: para. 42 and 103b). Insurance service expenses exclude reinsurance held expenses (IASB, 2017: para. 82).

Under the current accounting model, incurred claims should be recognised in profit or loss during the accounting period in which they are incurred. These claims include the cost of gross claims, adjusted for reinsurance claims recoveries and claims handling expenses. No provision should be made for future claims (SAICA, 2007).

The current model refers to the underwriting result, which is the operating result from providing insurance services. Unlike IFRS 17, the current model classifies insurance expenses by nature, according to the regulatory reporting structure. IFRS 17 improves this situation by providing the functions in which expenses should be aggregated, namely the insurance service expenses, reinsurance held expenses and the finance expenses.

4.13 Presentation

In terms of IFRS 17, an insurance contract, or a group of insurance contracts, is a single unit of account. Accordingly, an entity should present insurance contracts as a "combination of rights and obligations arising from a group of insurance contracts as a single insurance contract asset or liability in the statement of financial position" (IASB, 2017: para. BC328). An insurance contract gives rise to a liability for the remaining coverage and a liability for incurred claims. These insurance liabilities should be grouped and presented together on the statement of financial position and should not be offset against insurance assets (IASB, 2017).

Under the current model for short-term insurance, the only presentation guidance available for both the statement of comprehensive income and the statement of financial position is the FSCA's regulatory returns. The FSCA's returns present insurance assets and liabilities separately on the regulatory statement of financial position. Examples of these assets and liabilities are DAC, UPP, Outstanding Claims Reserves (hereafter OCR) and IBNR. Other items presented separately are the reinsurance share of technical provisions, for example reinsurance share of DAC, reinsurance share of IBNR, reinsurance share of UPP and reinsurance share of outstanding claims.

The presentation of both the statement of profit or loss and the statement of financial position improves under IFRS 17. In the statement of financial position, an insurer should aggregate and present separately all its insurance liabilities, insurance assets, reinsurance assets and reinsurance liabilities (IASB, 2017: para. 78). Thus, consistent with the presentation requirements of IFRS 4 (IASB, 2004: para. 14d), offsetting is not permitted under IFRS 17. The presentation improvement relates to the level of aggregation under IFRS 17, which removes various assets and liabilities and groups them together for the purpose of presentation in the statement of financial position. Disclosures provide the details of each balance presented in the statement of financial position.

IFRS 17 improves the presentation of the statements of financial performance by introducing the following changes:

- The presentation of revenue as a single measure of performance, which changes from gross written premiums, adjusted for the changes in UPP and reinsurance premiums,
- The separate presentation of the following items of financial performance:
    - insurance service expenses,
    - reinsurance held income or expense,

  - investment components and
  - finance costs or income, and
- Specification of the items of finance expenses or income that may be presented in OCI.

IFRS 17 does not allow the use of shadow accounting, which is optional under IFRS 4. Shadow accounting results in the recognition of some remeasurements of insurance liabilities in OCI. Rather, IFRS 17 has an accounting policy choice for the recognition of insurance finance income in profit or loss or the disaggregation of this amount to include the amount determined by a systematic allocation of the expected total insurance finance expenses or income over the coverage period of the group of contracts in profit or loss (IASB, 2017: para 88).

For insurance contracts with direct participation features, an entity has an accounting policy choice for the presentation of part of the insurance finance income or expenses in OCI. When an entity disaggregates finance income or expenses for contracts with direct participation features, the amount recognised in profit or loss eliminates accounting mismatches (IASB, 2017: para 89b). On the other hand, for insurance contracts without direct participating features, the amount recognised in profit or loss represents the systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts (IASB, 2017: para 88b).

Because contracts with participating features contain both insurance liabilities and assets that back those liabilities, IFRS 17 requires the entity to recognise in profit or loss any income or expenses that equal the income or expenses recognised in profit or loss for the underlying assets, resulting in the net of the two separately recognised items being zero (IASB, 2017: para. B134). The difference between the total insurance finance income or expenses for the period and the amount recognised in profit or loss should be recognised in OCI (IASB, 2017: para 90).

When insurance contracts are derecognised or transferred, IFRS 17 permits the reclassification of any remaining amounts previously recognised in OCI. However, for insurance contracts with direct participation features, the reclassification of any remaining amounts previously recognised in OCI to profit or loss is not permitted when the contracts are derecognised or transferred (IASB, 2017: para. 91b) because the objective of eliminating accounting mismatches cannot be achieved by such reclassification.

Presentation is one of the main deficiencies of the current accounting model. Financial statements prepared under IFRS 17 will show significant presentation improvement compared to the current model as a result of the changes discussed above.

4.14 Disclosure

IFRS 17's disclosure objectives are to enable users of financial statements to assess the effect that insurance contracts have on the financial statements of the reporting entity. Disclosures are required for both qualitative and quantitative information about:

- Identification and explanation of amounts recognised in the financial statements,
- Significant judgements made when applying IFRS 17 and any changes to those judgements, and
- The nature and extent of risks arising from insurance contracts.

The disclosure objectives of IFRS 4 under the current accounting model is for an entity to provide information about insurance contracts. That information should identify and explain the amounts in the financial statements that arise from insurance contracts so that users can understand the amount, timing and uncertainties about future cash flows arising from those insurance contracts. IFRS 4 identifies the following disclosure objectives:

- Identification and explanation of amounts recognised in the financial statements, and
- The nature and extent of risks arising from insurance contracts.

The disclosure objectives under IFRS 17 and the current accounting model are consistent. The notable addition to the current model disclosures to IFRS 17 is the inclusion of the third disclosure component in IFRS 17: the disclosure about significant judgements. Although this component is already a requirement of IAS 1, IFRS 17 adapts the disclosure requirement to insurance contracts.

The disclosure of significant judgements entails providing information about the inputs, assumptions and techniques used to measure insurance contracts within the scope of IFRS 17. IFRS 17 requires disclosures about the approaches used to determine the risk adjustment for non-financial risk, the discount rates used and the investment components. An entity is required to disclose the technique used to determine the risk adjustment for non-financial risk if it does not use the confidence level technique. Additionally, disclosures about the yield curve used to discount the cash flows are required. As these disclosures mainly relate to the measurement of insurance contracts, this is an improvement as IFRS 4 does not have guidance on measurement and hence no disclosures about measurement.

The Circular provides guidance on measurement of insurance contracts, but does not provide disclosure requirements. Hence IFRS 17 requires more detailed disclosures than the current model. In particular, IFRS 17 requires an entity to consider the level of detail necessary to satisfy the disclosure objectives and how much emphasis to place on each of the disclosure requirements. Where necessary, IFRS 17 requires the disclosure of additional information necessary to meet the disclosure objectives.

4.15 Conclusion

In this chapter, an assessment of the changes between the current accounting model for short-term insurance and the PAA model under IFRS 17 was performed. IFRS 17 was developed from principles established in IFRS 4. IFRS 17 establishes the principles for the recognition, derecognition, measurement and presentation of insurance contracts, in addition to the identification and disclosure requirements established in IFRS 4. The most significant improvements between the two models: the current model and the PAA, relate to the recognition and measurement of insurance contracts. The results of the assessment of the IFRS 17 PAA model as applied to short-term insurance contracts in South Africa are summarised in Appendix A.

Chapter 5. Conclusion

5.1 Introduction

The objective of conducting this research was to assess the adequacy of the changes from the current accounting model for short-term insurance to the PAA model under IFRS 17. To achieve the objective, a literature review of the current model and IFRS 17 was performed. Chapter 2 focused on the literature review of the current model, while in Chapter 3 the focus was on the PAA model under IFRS 17. An assessment of the changes between the two models was performed in Chapter 4. Appendix A summarises these research findings.

5.2 Current accounting model

The existing accounting model for short-term insurance contracts in South Africa, including reinsurance contracts held, is based on IFRS 4, Circular 2/2007 and the requirements of the STI Act. The Board Notice and APN 401 were issued to clarify the requirements of the STI Act in the determination of insurance liabilities. In addition, the FSCA is the regulator for insurance entities and the reporting requirements of the FSCA, which also fall under the STI Act, provide useful guidance for financial reporting of short-term insurance contracts and reinsurance contracts held by the short-term insurers. The current model classifies short-term insurance contracts according to the STI Act.

5.2.1. IFRS 4

IFRS 4 covers the identification and disclosure principles for insurance contracts. In addition, IFRS 4 contains some measurement and presentation principles and sets out the reporting requirements relating to changes in existing accounting policies. Because IFRS 4 is an interim standard, it permits entities to apply local GAAP in the areas of recognition and measurement, which are not covered by the standard. IFRS 4 states that a reinsurance contract is a type of insurance contract. Accordingly, all references in IFRS 4 to insurance contracts also apply to reinsurance contracts.

IFRS 4 requires the unbundling of deposit components when the entity can measure the components and its accounting policies do not require the recognition of rights and obligations from the deposit components. South African short-term insurers that had adopted the regulatory reporting requirements of the FSCA already recognise the rights and obligations from deposit components such as cash back bonuses as separate components of UPP, therefore are not required to unbundle those cash back components. Unbundled deposit components should be accounted for in terms of IFRS 9 and the premiums allocated to those components should not be recognised as revenue.

IFRS 4 does not permit an entity to recognise a liability for future claims such as catastrophe provisions and equalisation provisions. The standard requires an entity to perform a liability adequacy test at the end of each reporting period. Where the insurer is a holder of reinsurance contracts, IFRS 4 requires the entity to test reinsurance assets for impairment and if there is objective evidence of impairment, reduce the carrying amount of the reinsurance assets and recognise the impairment loss in profit or loss. An entity is not permitted to offset reinsurance assets, liabilities, income or expenses against similar items arising from the underlying insurance contracts. An insurer is required to provide disclosures about the amounts recognised in the financial statements and the nature and extent of risks arising from insurance contracts.

IFRS 4 provides a temporary exemption from applying IAS 8 for the development of accounting policies for the recognition and measurement of insurance contracts. Rather, it permits users to continue with their existing accounting policies for the recognition and measurement of insurance assets and liabilities. The Circular represents local GAAP, which covers the recognition and measurement of short-term insurance contracts.

5.2.2. Circular 2/2007

The Circular covers the recognition and measurement of short-term insurance contracts and reinsurance held in South Africa. It represents the local GAAP for short term insurance. The accounting model of the Circular for short-term insurance contracts is based on the recognition of earned premiums and incurred expenses over the risk period. The model focuses on the recognition of items in profit or loss with residuals deferred to the statement of financial position. These residuals are "trued up" by the regulatory measurement results of insurance liabilities. Liability adequacy and onerous contract assessments are required by IFRS 4, are also part of the Circular. The Circular permits the deferral of acquisition costs in the form of an asset called DAC.

5.2.3. Regulatory reporting (STI Act, APN 401 and the FSCA)

Due to the inadequate financial reporting guidance under IFRS 4 and the Circular, there is useful guidance in the regulatory requirements for short-term insurance contracts. The presentation of insurers' financial statements as well as the determination of insurance liabilities are not adequately addressed under IFRS 4 and the Circular. The regulatory reporting requirements provide guidance in these areas.

The STI Act returns (administered by the FSCA) are the only source of presentation guidance and the Board Notice is the only source of the method of determining insurance liabilities (IBNR, UPP and the unexpired risk reserve). APN 401 provides technical guidance to the actuaries who determine these insurance liabilities. The regulatory reporting structure permits the presentation of both written and earned premiums in the income statement of the insurer. In the regulatory statement of financial position, insurance assets and are reported separately as "technical assets." Other presentation guidance available in IAS 1 states that an entity ca use the current / non-current distinction or presentation based on liquidity.

5.3 IFRS 17: The PAA model

IFRS 17 provides guidance on the GMM, which identifies the components of measuring insurance contracts. These components are the fulfilment cash flows, discount rates, risk adjustment for non-financial risk and the contractual service margin. The PAA is the simplified measurement model, which does not require an entity to identify separately each of these components. Insurers have an accounting policy choice between applying the GMM and the PAA. For an entity to apply the PAA, the results of measuring the insurance contracts using the PAA should not differ materially from the results obtained by applying the GMM, or the coverage period of the group of contracts should be one year or less.

5.3.1. Recognition, modification and derecognition

Under IFRS 17, an issuer should recognise a group of insurance contracts at the earliest of the beginning of the coverage period, the date when the first payment is received from the policyholder or when the contract becomes onerous. In terms of IFRS 17, a group of insurance contracts should be derecognised once the obligations under the group are extinguished or significantly modified. When this happens, the initial contract qualifies for derecognition and a new contract with modified terms should be recognised.

5.3.2. Measurement

There is a presumption in IFRS 17 that when the coverage period of the group of contracts is one year or less, measuring it using the PAA would produce similar results to measuring it using the GMM. The "one year or less" coverage is the implicit measure for the "short-duration" coverage period. Many short-term insurance contracts fall within this coverage band. When an entity applies the PAA for measuring insurance contracts,

- the discounting of cash flows that are expected to be settled within one year is optional;
- the inclusion of insurance acquisition cash flows in the fulfilment cash flows is optional; alternatively these costs can be written off immediately when they are incurred,
- revenue recognition is based on expected premiums, not only received premiums,
- revenue recognition should be based on the passage of time or on the basis of the expected timing of incurred insurance service expenses,
- before claims are incurred, the insurance liability only consists of the liability for the remaining coverage, which is based on premiums received, and
- subsequently, the insurance liabilities should include a liability for the remaining coverage and a liability for incurred claims.

5.3.3. PAA for reinsurance contracts held.

In terms of IFRS 17, an entity should adapt the PAA requirements for contracts it issues for reinsurance contracts held to reflect that reinsurance contracts held result in reinsurance assets and the reduction of expenses rather than the generation of revenue. An entity can apply the PAA to measure a group of reinsurance contracts held on initial recognition provided the resulting measurement does not differ materially from applying the GMM requirements, or the coverage period of each contract in the group of reinsurance contracts held is one year or less.

5.3.4. Presentation

IFRS 17 requires the presentation of groups of insurance contracts that are assets separately from groups of contracts that are liabilities on the statement of financial position. The same requirement applies to reinsurance contracts that are assets and those that are liabilities. The offsetting of assets, liabilities or reinsurance balances against the underlying insurance balances is not allowed under IFRS 17. In the statements of financial performance, the standard requires the presentation of insurance revenue separately from insurance service expenses and finance income and expenses. Reinsurance held income or expenses should be presented separately in the statements of financial performance, either as a single net amount or by presenting the reinsurance held income separately from reinsurance held expenses.

5.3.5. Disclosure

According to IFRS 17, an entity should disclose information about amounts recognised in the financial statements of the entity that fall under IFRS 17. These disclosures include reconciliations of the opening and closing balances of the liability for the remaining coverage separately from the liability for claims incurred. The reconciliations should show the amounts recognised in the statement of profit or loss and the statement of other comprehensive income.

IFRS 17 requires detailed disclosures than the current model. In particular, IFRS 17 requires an entity to consider the level of detail necessary to satisfy the disclosure objectives and how much emphasis to place on each of the disclosure requirements. IFRS 17 requires the disclosure of additional information necessary to meet the disclosure objectives. This is an improvement compared to the current accounting model under IFRS 4.

An entity is required to provide disclosures about the significant judgements made by management when applying IFRS 17. These judgements relate the determination of contract boundaries, risk adjustments for non-financial risk, changes to estimates of fulfilment cash flows and the discount rates used. This is a new disclosure principle meant to address the measurement aspects of IFRS 17.

As IFRS 4 does not have measurement guidance, these disclosures are not available in IFRS 4. The Circular, which provides recognition and measurement guidance for short-term insurance contracts, does not provide any disclosure guidance. Therefore IFRS 17 improves the disclosure requirements for insurance contracts and aligns this principle with the requirements of IAS 1 about disclosures of the significant judgements made by management in applying accounting policies.

An entity should disclose information about the nature and extent of risks that arise from insurance contracts accounted for under IFRS 17. The entity is required to provide disclosures of the key sources of risk and how these risks are managed. The sources of these risks could be insurance related risks, for example the concentration of insurance risk, or financial risks which include credit risk, market risk and liquidity risks. An insurer is required to disclose information relating to the concentration of risks, a sensitivity analysis relating to insurance and market risks and the entity's claims development. These disclosures are consistent with the requirements of the current model in terms of IFRS 4.

5.3.6. Comparison of the PAA and Circular 2/2007

The PAA model under IFRS 17 is similar to the requirements of the Circular, which require the recognition of premiums over the coverage period and the recognition of claims on an "incurred" basis. There are however some differences between the PAA and the requirements of the Circular. For example, the PAA states the criteria for eligibility for applying the PAA, whereas the Circular refers to the STI Act for what constitutes a short-term insurance contract.

The treatment of acquisition costs is another area where the PAA differs from the Circular in that under the PAA, an entity has a policy choice to write off the costs in the period they are incurred or include the costs in the measurement of the liability for the remaining coverage. The Circular permits the creation of a DAC asset for acquisition costs that are not immediately written off. IFRS 17 does not require the liability adequacy as required by the circular because IFRS 17 requires the estimates of cash flows to be updated annually. Lastly, IFRS 17 has guidance for the PAA for reinsurance contracts held, something which the Circular does not address.

5.4 Assessment of IFRS 17's PAA model

The PAA is a simplified version of the general model of IFRS 17. On initial recognition, the simplification is that the liability for the remaining coverage is determined as the net of premiums received and acquisition cash flows paid. An optional eligibility assessment for applying the PAA should be performed for each group of contracts. IFRS 17 establishes the recognition principles for insurance contracts. IFRS 17 requires an insurance contract to be recognised at the earliest of the beginning of the coverage period, when the premiums become due for payment, or when the contract becomes onerous. The current accounting model has insufficient guidance relating to the initial recognition of an insurance contract

In terms of IFRS 17, an insurance contract qualifies for derecognition when the obligations under the contract are extinguished. A contract also qualifies for derecognition when the terms of the contract are so significantly modified that the terms of the modified contract differ from the original contract. When this occurs, the old contract should be derecognised and a new contract with the modified terms should be recognised. The current model requires derecognition of the insurance contracts only when the obligations are cancelled, expired or extinguished. IFRS 17 improves the derecognition requirements by adding modifications that result in the derecognition of a group of contracts.

IFRS 17 clarifies the requirements for determining contract boundaries. Cash flows are within the boundary of a contract if they arise from substantive rights and obligations that exist during the reporting period. The contract boundary ends when the entity has the practical ability to reassess the risks of the particular policyholder and reprice the contract to reflect those reassessed risks. The current accounting model does not provide guidance regarding when the coverage period begins and when it ends. The clarification in IFRS 17 is an improvement from the current accounting model.

Revenue recognition under both the current accounting model and IFRS 17 is based on the passage of time or the risk pattern of the insured events. This is the same as the requirements of the current accounting model. However, under IFRS 17, revenue is recognised based on expected premiums. Under the current accounting model, revenue represents the net earned premiums during the accounting period. Under both models, reinsurance premiums incurred should not be offset against premium income to determine insurance revenue.

IFRS 17 allows a policy choice for the treatment of insurance acquisition cash flows. In terms of IFRS 17, insurance acquisition cash flows should be included in the measurement of the liability for the remaining coverage, or expensed when incurred, as permitted under the PAA, if the coverage period is one year or less. IFRS 17 does not permit raising an asset for DAC. The only exception is when acquisition cash flows are incurred before the initial recognition of the group of contracts, IFRS 17 allows a policy choice between expensing these costs and creating an asset.

If an asset is raised, it should be derecognised on initial recognition of the group of contracts. Under the current accounting model, an entity can capitalise DAC in the form of an asset, and commission is recognised in profit or loss over the period of risk covered by the insurance contract. Both models are clear about the treatment of acquisition cash flows, but IFRS 17 takes a different approach from the current accounting model. Assessing the appropriateness of this change is beyond the scope of this research.

The measurement of insurance contracts in terms of IFRS 17 results in two components of the insurance liability: the liability for the remaining coverage and the liability for incurred claims. Under the PAA, the liability for the remaining coverage represents an entity's obligations under the contract to compensate the policyholder for insured risks. It relates to unexpired coverage periods for which premiums have been paid. The liability for the remaining coverage represents UPP under the current accounting model.

The determination of UPP under the current model differs with the determination of the liability for the remaining coverage under the PAA. In terms of the PAA, the liability for the remaining coverage should be based on premiums received. Under the current model, UPP is based on gross premiums receivable. Under the PAA, there is a policy choice between writing off acquisition costs when they are incurred and including them in the measurement of the liability for the remaining coverage. Under the current model, a DAC asset is created and is not absorbed into the measurement of UPP. The current accounting model does not require the discounting of insurance liabilities. Under the PAA, discounting is not required if the time between providing each part of the coverage and the premium due date is less than a year. Otherwise discounting is required.

The liability for incurred claims represents the entity's obligation to investigate and compensate policyholders for claims incurred. The obligation relates to past services. At each reporting date, the reporting entity should update the estimates for fulfilment cash flows so that they are current. The changes in the insurance liabilities should be recognised in profit or loss, if the changes are not due to settlement of the obligations. Under the current model, an entity should raise a liability, to the extent unpaid, of all claims incurred to the reporting date, whether reported or not. There is no difference between the current model and the PAA, except that the current model does not require the discounting of the insurance liabilities. Under the PAA, discounting is required if the cash flows are expected to be paid or received more than one year after the claims are incurred.

Deposit components under IFRS 4 are the same as investment components under IFRS 17. The unbundling requirements of deposit components under IFRS 4 changed under IFRS 17 for the separation of investment components. IFRS 17 requires only the separation of distinct investment components from the host insurance contracts. Under the current model, IFRS 4 requires the unbundling of the deposit component if it can be measured and the accounting policies do not require the recognition of rights and obligations arising from the deposit component.

Both IFRS 4 and IFRS 17 require the separation of the investment or deposit component, but IFRS 17 goes a bit further by requiring the separation of distinct components, rather than the measurability criteria required by IFRS 4. IFRS 17 improves the separation criteria because under IFRS 4, interrelated components could be separated as long as the measurability criteria is met and provided no accounting policies require the separate accounting of the deposit component before the unbundling takes place.

IFRS 4 ignores the interrelationship between the insurance component and the deposit component. Both models require the separated component to be accounted for under IFRS 9. Both models do not permit an insurer to include the component of premiums relating to the investment component in revenue or repayments of the investment components in claims incurred. IFRS 4 is silent on the presentation in profit or loss, except that the premiums for the deposit component should not be accounted for as revenue but rather as changes in the deposit liability. Similarly, IFRS 17 requires the investment component to be part of the liability for the remaining coverage, unless it is transferred to the liability for incurred claims when the policyholder becomes entitled to the repayment.

Reinsurance contracts held should be accounted for in the same way as insurance contracts, except for certain modifications required by IFRS 17. These modifications are necessary to reflect the fact that reinsurance contracts held are generally assets and that the purpose of taking out reinsurance is not to make profit. Consequently, IFRS 17 states that reinsurance contracts held cannot become onerous since they are assets. The current accounting model is silent about adapting the requirements for insurance contracts to suit the nature of reinsurance held contracts. Therefore IFRS 17 provides better clarification about the approach taken for reinsurance contracts held.

IFRS 17 does not specifically require impairment testing of the reinsurance assets, but requires that the fulfilment cash flows incorporate the risk of non-performance by the reinsurer and other losses that may arise from disputes. The current accounting model requires the impairment testing of reinsurance assets. The current model uses the incurred loss model of IAS 39 for the impairment of reinsurance assets. IFRS 17 places less emphasis on the impairment of reinsurance assets compared to the current accounting model.

IFRS 17 requires the separate presentation of groups of insurance contracts that are assets, insurance contracts that are liabilities, reinsurance contracts held that are assets and reinsurance contracts held that are liabilities. There is a significant improvement in the presentation of the statements of financial performance. Under the current model, the regulatory reporting presentation structure is the only presentation guidance available for short-term insurers. The new structure aligns the financial statements of insurers with those of non-insurers and improves comparability.

There are similarities between the current accounting model and the PAA and it is possible for most short-term insurance contracts to be eligible for the PAA model of IFRS 17. The PAA approach is intended to replace the current accounting model for short- term insurance. Most short-term insurance contracts as defined in the STI Act are likely to meet the eligibility criteria either on the basis of the one year coverage period or on the approximation of the measurement to the GMM.

Overall, IFRS 17 has introduced significant improvements to the accounting for insurance contracts. IFRS 17 provides a single source of accounting guidance for short-term insurers, and provides more guidance for reinsurance accounting, except that it does not contain an impairment model for reinsurance assets. IFRS 17 improves the financial reporting requirements of short-term insurance contracts with the exception of a few areas that remain the same between the current model and IFRS 17.

5.5 Areas for further research

The practical implementation of the PAA may prove challenging in certain areas. The following areas may pose practical difficulties relating to the implementation of the PAA:

- The main condition relating to the use of the PAA is that the measurement results produced by applying the PAA should approximate those of the GMM. At initial recognition, the GMM is somewhat subjective to apply to short-term insurance contracts because of the uncertainties relating to the amounts and timing of claims (at contract inception, an entity must estimate the amount and timing of future claims). Claims are a major component of the fulfilment cash flows of an insurance contract. Therefore it is likely to be difficult to ascertain, at policy inception, whether or not the PAA measurement will approximate the GMM.
- The determination of contract boundaries for short-term insurance contracts is likely to be a challenge, since most short-term insurance contracts are issued for indefinite periods. Besides the issue of contracts issued for indefinite periods, there are also contracts with cash back components. Whether the cash back bonus period will impact on the contract boundary is another area that may pose practical implementation issues.

- The PAA requires an entity to recognise IBNR and the risk adjustment for non-financial risk in the measurement of the liability for incurred claims. The measurement techniques for these components are likely to pose practical difficulties as the standard does not provide sufficient application guidance for the measurement of these components.

Interviews with major role players in the short-term insurance industry, especially those individuals or teams responsible for financial reporting, may provide useful information and contribute to further research in this area.

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Appendix A

Summary of research findings on the assessment of IFRS 17's PAA model as applied to short-term insurance in South Africa

	Area	Current model	PAA	Assessment
1	Unit of account	Not defined	Contract	Improvement
2	Initial recognition of a contract	Insufficient guidance	New guidance (section 4.3)	Improvement
3	Separating investment components	IFRS 4 contains guidance for unbundling.	Guidance refined (section 4.7.3)	Improvement
4	Modification	Silent	New guidance (section 4.4.1)	Improvement
5	Derecognition	Sufficient guidance	Sufficient guidance (section 4.4.2)	No change
6	Contract boundaries	Refers to the period of risk covered by the insurance contract. The period is not defined.	Period over which the insurer is required to provide insurance coverage and the policyholder is compelled to pay insurance premiums for the cover (section 4.5).	Clarified, but is subjective and could provide uncertainties in practice.
7	Measurement model	Circular 2/2007 for short-term insurance contracts defined in the STI Act.	New guidance. PAA is a simplified model that could be applied in certain circumstances (section 4.6).	Improvement – PAA is based on the nature of contracts and the related risks.
8	Liability for the remaining coverage: Measurement on initial recognition	UPP based on gross written premiums	Liability for the remaining coverage based on premiums received, adjusted for insurance acquisition cash flows, risk adjustment and time value for money (section 4.7.1).	Improvement
9	Liability for the remaining coverage: Subsequent measurement	UPP based on gross written premiums, adjusted for changes in UPP recognised in revenue.	Opening balance is adjusted for premiums received, revenue recognised, insurance acquisition cash flows, investment components risk adjustment and time value for money (section 4.7.2).	Improvement

	Area	Current model	PAA	Assessment
10	Liability for incurred claims	Outstanding claims and IBNR. Estimates are updated at the reporting date for new claims, experience adjustments and payments.	When losses occur, it is measured on the estimate of fulfilment cash flows (including IBNR), adjusted for time value of money and the risk adjustment. Estimates are updated at the reporting date for discounting, investment components, risk adjustment, new claims and payments (section 4.8).	Improvement
11	Techniques for determining IBNR	Silent: some insurers use regulatory reporting requirements.	Silent.	No change
12	Reinsurance	Reinsurance held premiums should be expensed and reinsurance issued premiums should be recognised as revenue.	There are no separate requirements for reinsurance issued since the accounting requirements do not differ from those of insurance contracts issued. Separate accounting guidance for reinsurance held (section 4.9).	Clarified
13	Measurement uncertainty	Addressed by prudence.	Incorporation of the risk adjustment for non-financial risk (section 4.8.2).	Improvement
14	Revenue	The current practice is to adjust earned premiums by reinsurance premiums expense incurred. Excludes premiums allocated to deposit components.	Revenue earned represents the change in the liability for the remaining coverage, excluding investment component, and the insurance finance income or expense (section 4.10).	Clarified / Improvement
15	Acquisition costs	Capitalised as a DAC asset and amortised over the coverage period.	Expensed when incurred or included in the measurement of the insurance contract (section 4.11).	Clarified
16	Insurance service expenses	Not defined under the current model, but are deducted from net	Consist of incurred claims, amortisation of insurance acquisition	Clarified

	Area	Current model	PAA	Assessment
		earned premiums to get the underwriting result.	cash flows, experience adjustments, losses on onerous contracts (section 4.12).	
17	Investment components (including cash back bonuses)	Deposit component unbundled if it can be measured and accounted for under IFRS 9.	Investment component separated from host if it is distinct and accounted for under IFRS 9. If not distinct, accounted for under IFRS 17, but excluded from insurance revenue and insurance service expenses (section 4.7.3)	Improvement
18	Insurance finance income or expense	Discounting insurance liabilities is an option.	Discounting is required when settlement is expected after more than one year from the loss event date (section 4.13).	Improvement
19	Presentation in the statement of financial position	Presentation in the statement of financial position is based on IFRS 4. IFRS 4 prohibits offsetting of insurance assets and liabilities against reinsurance liabilities and assets.	IFRS 17 requires the separate presentation of insurance contracts that are assets and that are liabilities. The same requirement applies to reinsurance contracts that are assets and that are liabilities (section 4.13).	Clarified
20	Presentation in the statements of financial performance	Presentation in the statement of profit or loss is based on the regulatory reporting structure of STI Act insurance returns. IFRS 4 does not contain a presentation structure for the statement of financial performance of insurers.	IFRS 17 has new presentation requirements for both the statement of profit or loss and OCI. These require the separate presentation of revenue, insurance service expenses, reinsurance income or expense and insurance finance income or expense (section 4.13).	Improvement
21	Recognition in other comprehensive income	Shadow accounting had the option to account for changes in insurance liabilities though OCI.	Changes in the base rate used to discount insurance liabilities can be recognised in OCI. Reclassification adjustments are permitted on derecognition or transfer	Improvement

	Area	Current model	PAA	Assessment
			of the group of contracts (section 4.13).	
22	Recognition in OCI	Silent about recognition in OCI.	Certain amounts can be recognised via OCI but reclassifications to profit or loss are prohibited (section 4.13).	Improvement
23	Impairment model for reinsurance assets	Incurred loss model based on IAS 39.	No comprehensive impairment model for reinsurance assets. The only requirement is for an entity to consider the default risk of the reinsurer, including the effects of collateral and losses from disputes (section 4.9).	No clear improvement